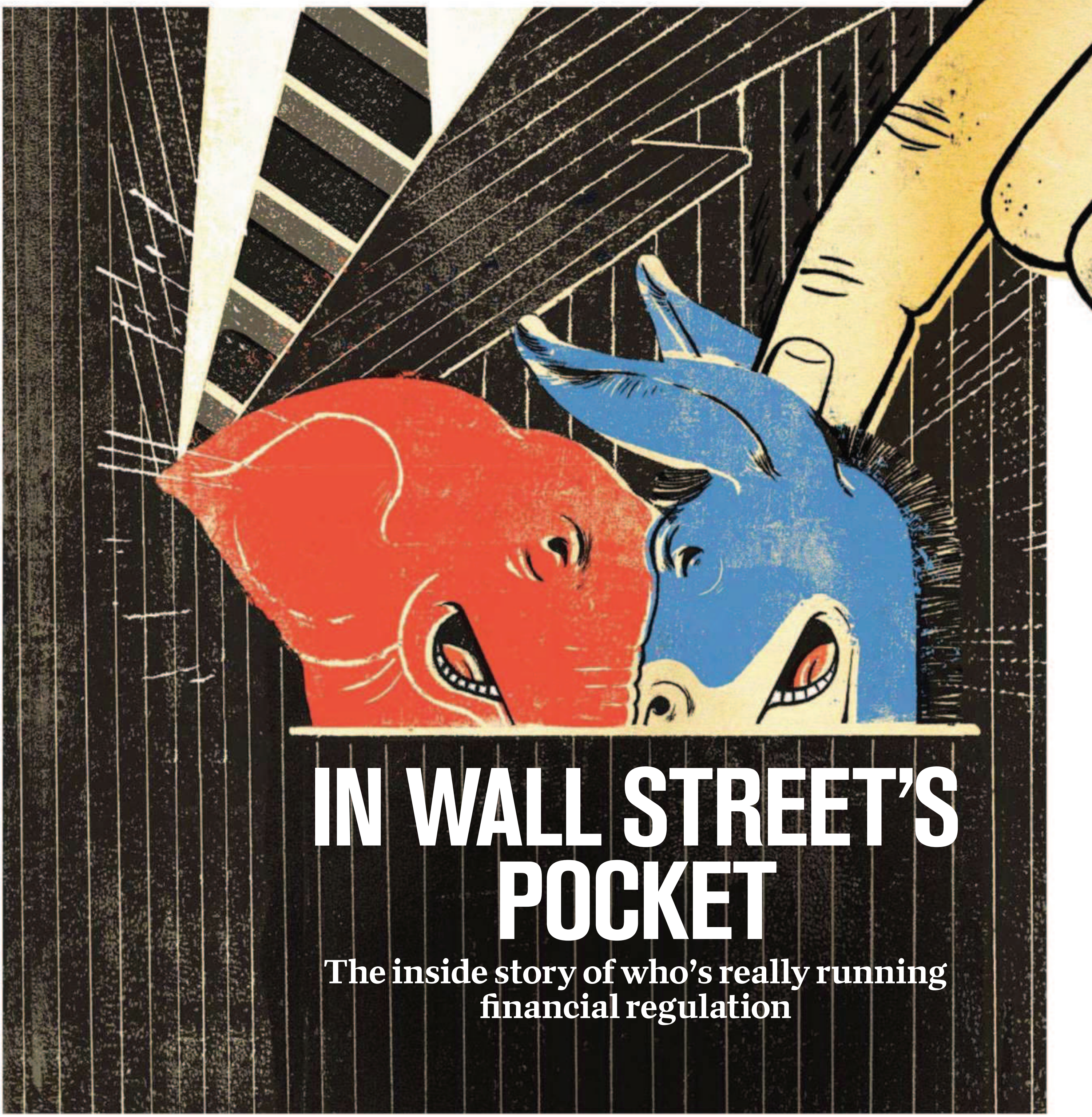
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Bloomberg BusinessWeek In Depth



Army Sergeant Patrick Peake earned a bachelor's degree in criminal justice while in Afghanistan

COVER ILLUSTRATION BY EDEL RODRIGUEZ; (TOP) PHOTOGRAPH BY STEVE JONES

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BusinessWeek

The Global Report



Paul Volcker

The Week in Business

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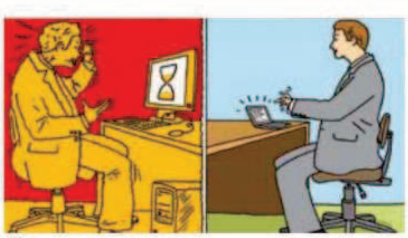
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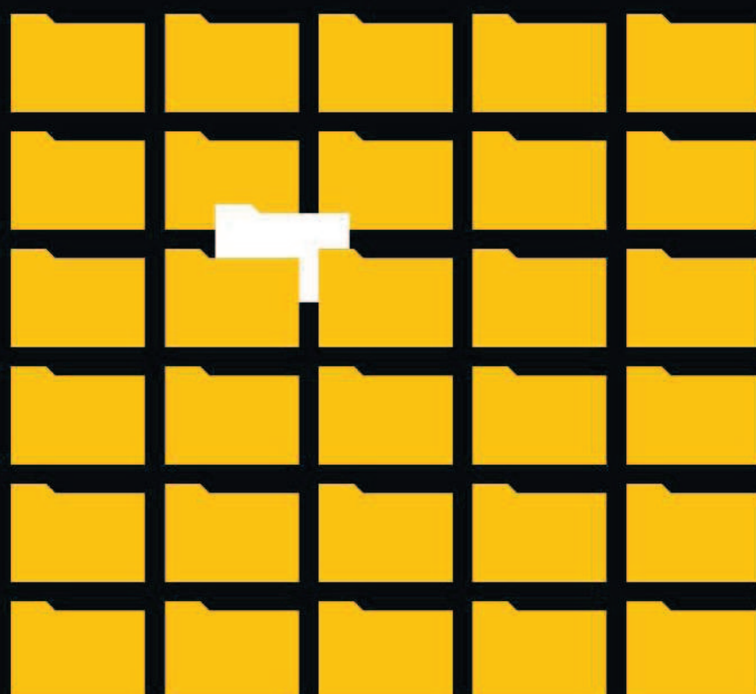
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Edited by
Harry Maurer and
Cristina Lindblad

THE WEEK IN BUSINESS



Macy's flagship store before Christmas: Shoppers spent more freely

DIANE BONDAREFF/AP PHOTO

ECONOMICS AND POLICY

THE MALLS ARE ALIVE

It wasn't a dazzling performance, but American shoppers did their bit for the economy this Christmas. The **International Council of Shopping Centers** (ICSC) and **Goldman Sachs** reported on Dec. 29 that U.S. retail sales climbed by a higher-than-expected 2.3% during Christmas week, which will push the month's sales gain to about 2%. "We have definitely turned the corner," said ICSC chief economist **Michael Niemira.** "We are in a retail recovery, but it's not going to be smooth sailing." Niemira predicts sales growth in 2010 of as much as 3.5%. Part of the reason: Consumers feel a bit cheerier. The **Conference Board's** confidence index rose for the second straight month in December, to 52.9, more than double its low of 25.3 in February 2009. The slide in housing prices continues to moderate, and the S&P 500 closed at 1126.20 on Dec. 29, meaning that it has recaptured half the ground it lost from October 2007's peak through March 2009's nadir.

"Key Home Price Index Rises for Fifth Month" businessweek.com/magazine

27.7%

Total return of the S&P 500 for calendar year 2009*

*Through Dec. 29
Data: Bloomberg

TROUBLE FOR CHINA MOBILE

The cell-phone operator with the biggest number of subscribers in the world may be headed for some turmoil at the top. On Dec. 27, China Mobile issued a statement that **Vice-Chairman Zhang Chunjiang** is under investigation by authorities for "serious personal violations." While the company didn't elaborate further, that language has often been used in China as code for corruption, a chronic affliction at big, state-run companies. In July the former head of oil giant **Sinopec** was convicted of taking $28 million in bribes, and in August the ex-chief of a company that manages many Chinese airports was executed for similar crimes. Zhang joined China Mobile in June after

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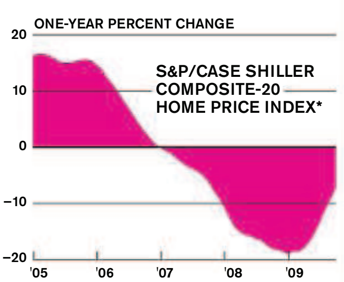
EXECUTIVE SUMMARY

serving as head of state-owned **China Netcom.**

CRUDE CLIMBS SOME MORE

Crude futures rose above $79 a barrel to a five-week high on Dec. 28 as the dollar strengthened and weather cooled. But pundits couldn't agree less over what comes next: **Goldman Sachs** forecasts an average of $94 in 2010, while trader **Phil Flynn** is shorting oil, which he says could go as low as $40. Underlying such projections are conflicting assumptions about fundamental forces. Those betting on a price surge think the flow of oil is going to dwindle; bears, however, think the market is already saturated and that the glut will only grow. Edward Morse, a New York oil analyst, argues that the bulls "have been smitten by the commodities world of 2003-08," when the oil price runup topped out at $147 a barrel.

THINGS ARE LOOKING UP



Data:Bloomberg *Seasonally adjusted

CHINA GETS GREENER

Buy green juice—or else. That's the message China's legislature sent on Dec. 26, when it passed an amendment requiring its power grid to purchase all energy produced exclusively through renewable sources including wind, solar, and hydropower. China, sitting on the world's greatest cache of coal, still generates the great bulk of its electricity in highly polluting coal-fired plants and only 9% via alternative sources. Under the new rules, utilities that spurn renewable energy—even if it's more costly—may face stiff fines. Still, the transition won't be simple, since much of the grid at present can't handle fluctuating supply from wind and solar sources.

FINANCE

BONUS? NOT SO FAST

Wall Street bankers who expected to collect handsome bonuses for their 2009 performance may have to keep up the good work for a few years. **Morgan Stanley,** the second-biggest U.S. securities firm after **Goldman Sachs,** plans to defer at least 65% of yearend bonuses for its top 30 executives and link the restricted payments to profitability and share-price gains, said a person familiar with the matter on Dec. 29. Goldman an-



An Iraqi oil field: Crude prices have been rising steadily, but will that last?

PHOTOGRAPH BY ATEF HASSAN/REUTERS; CHART BY DAVID FOSTER



EXECUTIVE SUMMARY



GM is trying to unload leftover Pontiacs

nounced on Dec. 10 that yearend awards would be conferred in stock that can't be sold for five years. Investor advocates argue that tying pay to long-term performance may shelter shareholders from losses sown by bankers who have long since collected their bonuses and split.

A RICH EXIT FROM AIG

The Wall Street Journal reported on Dec. 29 that **American International Group** plans to pay ex-**General Counsel Anastasia Kelly** several million dollars after she quit because of pay curbs imposed by Washington. She's entitled to the money, insiders told the *Journal*, under company rules that say certain executives can quit and still get severance if their pay gets chopped. Kelly was already under scrutiny by AIG's board for advising other managers on how they could protect their rights to win severance. Early in December, Obama Administration "pay czar" **Kenneth Feinberg** capped pay for most executives of the bailed-out firm at $500,000, a sharp cut for Kelly.

STRATEGY

PSST! WANT A PONTIAC?

General Motors is so eager to get rid of leftover Pontiac and **Saturn** models that it plans to give dealers $7,000 per car to shunt the vehicles into their used-car lots, where they will be employed as service fleet cars or loaners. Then the dealers can sell them at lower prices, since they will be considered used. Dealers must take GM up on the offer by Jan. 4. The carmaker aims to move the inventory so it can quickly finish liquidating the Pontiac and Saturn brands. GM is also selling **Hummer** to a Chinese company and trying to offload **Saab** in order to concentrate on **Buick, Cadillac, Chevrolet,** and **GMC** trucks.

SOUTH KOREA'S NUKE DEAL

It's the first nuclear contract awarded by a Gulf Arab nation, and the winner surprised nearly everyone. On Dec. 27 a group led by **Korea Electric Power** snared a $20 billion deal to build four nuclear plants in the **United Arab Emirates,** beating out groups led by **General Electric** and France's **Areva.** The Koreans may earn another $20 billion over 60 years for operating the UAE plants, according to the South Korean government. Analysts figure the contract presages strong growth for the industry in the next two decades, with the UAE's program expected to prompt other Gulf states to seek nuclear reactors as well. South Korea has never before exported its nuclear technology, but **Korea Electric,** a state-run utility, says it is in talks with Turkey to build two reactors near the Black Sea and is competing for eight more orders from countries including China, India, and Jordan.



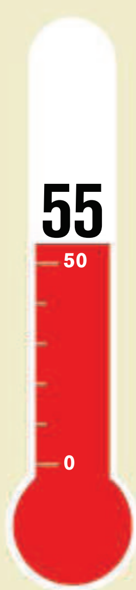
Zoe Saldana in *Avatar*: The film helped Hollywood set a new box-office record

A BOFFO WEEKEND

DVD sales may still be sagging, but the blockbuster openings of **James Cameron's** 3D sci-fi extravaganza, ***Avatar,*** and ***Sherlock Holmes,*** starring **Robert Downey Jr.** as a disheveled version of the fabled detective, provided Hollywood with a sweet yearend gift. A record $278 million Christmas weekend box office catapulted ticket sales for the year past $10 billion for the first time, with attendance running 5% ahead of last year—though still well below the peak year of 2002. With a domestic box office take of $232 million as of Dec. 28, Avatar will zoom past $300 million by New Year's Day, according to analysts, and eventually ring up as much as $400 million in the U.S. Together with ***Alvin and the Chipmunks: The Squeakquel,*** which has grossed more than $70 million, that could give **News Corp.'s Fox** studio two $100 million Christmas flicks.

THE OPTIMISM METER

CAUSES FOR CHEER



The Meter clocked in at 55 on Dec. 26, up from 46 a month earlier as the outlooks for U.S. equities, employment, and housing all improved. The forecast for the U.S. economy, however, grew a little less rosy. Developed by ***Bloomberg BusinessWeek*** using data from pollster **YouGov,** the Optimism Meter is a proprietary measure of sentiment and expectations, economic statistics, and market forecasts. It tracks shifts in outlook among individuals, professional investors, and economists about jobs, markets, real estate, and growth.

*Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest
Data: YouGov, *Bloomberg BusinessWeek*

(TOP LEFT) SCOTT OLSON/GETTY IMAGES; (TOP RIGHT) 20TH CENTURY FOX/COURTESY EVERETT COLLECTION

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- Al Gore, November 5, 2009
Former Vice President of the United States,
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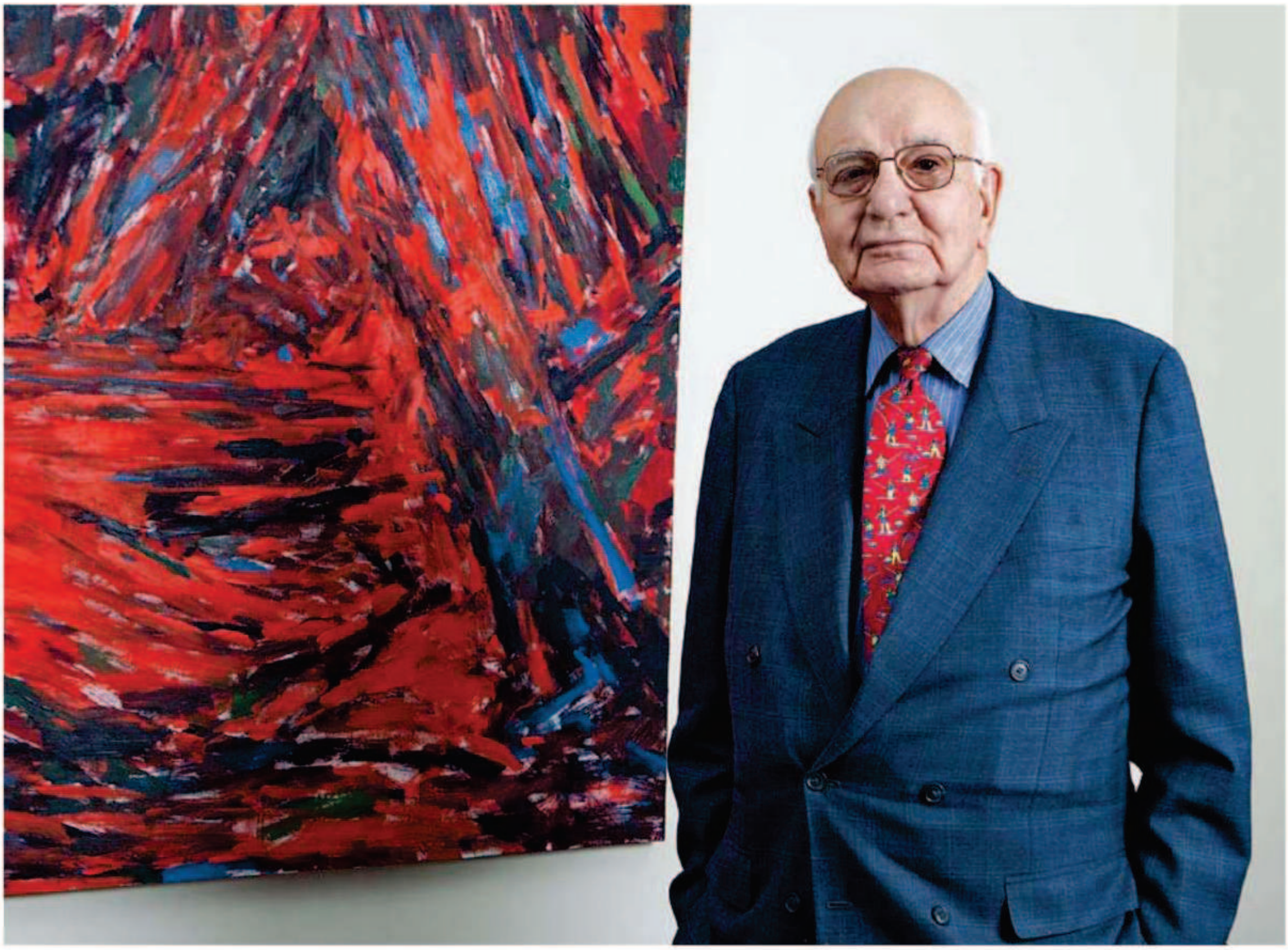
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[1] Al Gore Speech at The George Washington University, Washington, D.C., November 5, 2009. These quotations are based on an audio recording provided by Politics and Prose, Washington, D.C., http://politics-prose.com.

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AT THE TABLE CHARLIE ROSE





(FROM TOP) PHOTOGRAPHS BY LOUIS LANZANO/AP PHOTO; CHRISTOPHER LANE

PAUL VOLCKER
THE LION LETS LOOSE

There has been chatter in recent months about Paul Volcker, the chairman of President Barack Obama's Economic Advisory Board, being muffled by the Administration—especially when it comes to his views on bank regulation. But that hasn't stopped Volcker from taking his argument for separating commercial and investment banking on the road, scolding bankers in Britain in early December and telling politicians in Germany that "this is no time for a return to business as usual." The former Fed chairman has also been hard at work leading a panel that will report back to the President early next year with proposals for tax reform. And at 82, he recently got engaged. We talked at Volcker's Manhattan apartment on Dec. 29.

CHARLIE ROSE
What will economic growth look like in 2010?

PAUL VOLCKER
Economists are terrible at forecasting, but it's going to be a slog. The most recent figures are a little bit better than we would have expected, but that doesn't mean they're very strong.

And jobs?
Jobs are going to be slow to recover.

A permanent loss of jobs?
No, we shouldn't have a permanent loss of jobs, but we have a considerable adjustment process to go through here. We've got to restore investment, we've got to restore our manufacturing industry, not the old-fashioned manufacturing industry, but we have

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to do a better job at the new industries that are coming along—the so-called green economy. Other countries are ahead of us in production that's related to change.

How did that happen?
What happened is our best and brightest got attracted to Wall Street. You've read about those big bonuses. These are generalizations, but I do think that the pull of Wall Street on bright young people, ambitious young people, has been tremendous.

Will it change?
I think we're in the process of change now. Wall Street hasn't got quite the glamor that it had a few years ago.

Yes, but I hear bonuses are coming back.
Well, I hope you'll get more competition on Wall Street and get some reforms, and profitability won't seem quite so great. At one point, Wall Street had almost 40% of all the profits in the country. And, you know, its contribution to the welfare of the country does not approach 40%. Something's out of line here.

Let's talk about the financial system. You have said it failed the test of the marketplace.
Yes. It collapsed on us. And I think that's the test of a financial system—is it facilitating reasonable stability and growth? No, it's had a breakdown at great risk to the economy. It became dysfunctional, and it is still largely dependent upon government assistance.

How should we create a well-oiled financial system?
The kind of reform I've been advocating is acceptance of the fact that the core of the system remains commercial banking. If that breaks down then you have an enormous crisis. And commercial banks have expanded into areas I don't think are so central. I would cut back their so-called capital market activities—hedge funds, equity funds, commodities trading, trading in derivatives. They're all legitimate functions, but they're not so central. And I don't want to protect all those functions. I don't want to protect everybody because when people act like they're protected, you get in trouble. So let's leave the capital markets to their own devices without any expectation of government protection and keep the existing safety net for the commercial banking system.

In my judgment we don't need to regulate the capital markets so heavily. You have some extreme cases where individual institutions are so big and so vulnerable, yes, you might want some regulation of capital and leverage, but that would be the exception. But if they fail, let 'em fail. We will have some kind of a new resolution process. Some agency will go in there and say, "You're going to fail, but we're going to provide a more orderly exit."


FDR signing the Glass-Steagall Act in 1933

BETTMANN/CORBIS

But if you're a commercial bank, no matter how big you are, you should not be allowed to fail?
I wouldn't go so far as to say you're not going to be allowed to fail, but you're going to have a lot more protection available so that it would take pretty extreme circumstances to fail to the point that the institution disappears. The quid pro quo for that is more regulation and a limitation on your activities. I don't want [commercial banks] out doing a lot of speculative trading.

So does this mean we should restore Glass-Steagall?
No. That's a false statement people make about my position. Glass-Steagall basically said banks cannot underwrite corporate securities or deal with corporate securities. But I would let commercial banks do underwriting of corporate customers. So you could argue that what I propose is somewhat in the spirit of Glass-Steagall in making a distinction between capital-market activities and trading activities and banking activities. But it is not specifically going back to Glass-Steagall.

Do you think that Congress will see it your way?
Eventually, yes. They need a little more persuasion.

So why haven't your views prevailed with the Administration?
I wasn't persuasive enough.

How many meetings have you had with the President about this?
Not very many but ... the President has heard my arguments a number of times.

Has he heard them one on one, where you've had an opportunity to say "This, Mr. President, is why you need to make sure that commercial banks..."
That's not the way the process works.

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But do you feel like you have had sufficient opportunity with the President to make your case?

Well, what's sufficient? He's the President. He decides.

You have one of the most powerful and persuasive voices in the global financial conversation.

You flatter everybody. I am one voice in the conversation, and there are others.

Does Ben Bernanke agree with you?

I don't want to speak for him. He can speak for himself.

Britain now has a system in which they tax 50% of financial bonuses. What would you do as far as compensation goes?

I've thought about this, and I don't know the answer. I think the whole system is broken, frankly. The best article I've seen about this was in *The Wall Street Journal* a week or two ago. Some professor said: "Let's get rid of all the stock compensation business. It all gives bad incentives. It's the wrong way to go about it. You ought to pay a guy cash, pay him a salary, pay him a bonus if you decide that he's done a good job. But don't attach a lot of criteria that he's going to manipulate to his advantage."

Isn't that exactly what they do on Wall Street? They basically say, if you've brought in $50 billion worth of business, then we're prepared to give you a huge income?

Sometimes they do it on the basis of stock and sometimes not. That isn't going to solve all the problems, I agree. But you take the trading guy who says: "I brought in $100 million worth of profits, therefore I want $25 million." Have they really taken into account that this trading guy is going on [the firm's] reputation, capital, and risk when he went out there and made the $100 million? If he's so good, let him go out and do it himself.

Wall Street has a history of creating financial instruments that will meet any new challenge. Any reason to believe that's going to stop?

No. They will continue to try to get around all these restrictions. You have to have a much stronger supervisory and regulatory apparatus to have any chance of keeping up with that.

You feel strongly that the financial system has gotten out of whack. Do you think the American political process is capable of fixing it?

The American political process is about as broken as the financial system. Therefore, one has to be a bit skeptical. Just to give you one little example, one unrelated to the financial crisis. Here we are on Dec. 29, almost a year after the Inauguration, and there is no Under Secretary of the Treasury. That should be an important position. How can we run a government in the middle of a financial crisis without doing the ordinary, garden-variety administrative work of filling the relevant agencies? The Treasury is an outstanding example of a broken system, but it's not the only one.

Is part of the problem that Congress is slow in the process of approving?

Slow is too fast a word to describe what's going on. The Administration is one quarter over, and it hasn't manned the ramparts of government yet.

So it's the Administration's problem? They haven't gotten their Executive Branch in place?

It's partly a reflection of the discord in government and extreme views on either side and fighting each other for every scrap of advantage.

In interviews in the past you said that's why we needed to change the political process; that's why you thought that candidate Obama was the best choice for President.

True. But has he been able to do that at this point? It doesn't look that way. I think that's unfortunate. I wish the Administration would pay more attention to what's needed to improve the ordinary functioning of government. We can't even fight a war with our own people any more. We've got to hire Blackwater. I think people have lost confidence in government, they've lost trust in government, and it shows. This isn't a question just of this Administration. It's been kind of a steady, downhill path.

Yes, but this Administration came in and said it would change. That was the mantra of the campaign. So what happened?

It shows you it's not that easy to change. | BW |

I DON'T WANT TO PROTECT EVERYBODY BECAUSE WHEN PEOPLE ACT LIKE THEY'RE PROTECTED, YOU GET IN TROUBLE.... IF [FIRMS] FAIL, LET 'EM FAIL

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BUSINESS OUTLOOK | MARK GILBERT

THE FED'S NEXT ACT COULD BE ITS HARDEST

U.S. financial policymakers have managed to ease the recession with extraordinarily aggressive actions. But crafting a return to normalcy will be the real test

For more than a year, central bankers from Washington to Warsaw have kept the world economy on life support by pumping massive amounts of liquidity into the global financial system. Now comes the hard part: Removing the tubes without killing the patient. For 2010, the hot topic for the guardians of financial stability will be how to engineer an exit strategy that reduces the burden on the taxpayer without risking a double-dip recession. Stock investors seem increasingly confident that it can happen, but it's far from certain such a delicate procedure can be successful.

The amount of stimulus thus far is staggering. The Federal Reserve and other U.S. agencies have lent, spent, or guaranteed \$8.2 trillion in emergency funds to resuscitate growth. The Fed's balance sheet has picked up \$2.24 trillion of assets, a gain of 142% since the beginning of 2008. U.S. public debt has surged to \$7.7 trillion, according to the Treasury Dept., up from \$6.4 trillion a year ago and from an average of \$5 trillion in 2007 (chart).

\$1.7

Value of assets, in trillions of dollars, written down globally by financial firms during the credit crisis

Data: Bloomberg

Efforts by central bankers to turn off the financial spigot are focused so far on esoteric corners of the money markets. The Fed, for example, plans soon to phase out both its Term Securities Lending Facility and its Primary Dealer Credit Facility, which loaned money to banks in return for taking their distressed assets as collateral. A bunch of other acronymic funding channels unveiled during the crisis will also close.

Meanwhile, the European Central Bank in December changed the terms of the 12-month loans it has been making to banks. The ECB switched to a floating rate tied to its policy benchmark, from a previous fixed rate of just 1%, to ensure that banks share the pain once it decides to start driving up borrowing costs. The Bank of England, which has been buying company debt as a way of funneling cash into the system, said last week it will start offloading some of those bonds in January to boost trading.

That kind of technical tinkering at the edges, while essential, avoids the big question: When will central banks start to raise the interest rates that affect the lives of the ordinary folk who have often unwittingly—and perhaps unwillingly—underwritten these trillion-dollar safety nets?

For now, at least, the financial futures market is convinced lending rates will hold steady. The dollar futures contract that settles in December 2010—a guide to where traders expect three-month borrowing costs to be at the end of next year—shows a rate of about 1.4%. While that's way more than the current 0.25% cost of borrowing the U.S. currency for 90 days, the futures level has been ticking down since midyear and is more than a percentage point lower than it was in August.

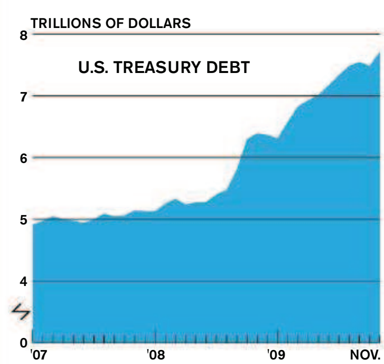
It's a similar story in other currency markets. Buyers of the December 2010 euro contract have reduced their bets on where three-month money is headed to 1.7% from 2.6% four months ago; the British pound version is down to 1.9% from 2.4% two months ago.

Traders are forecasting lower rates even as the equity market suggests the global economy is mending. One reason: stubbornly high unemployment, which could stay the Fed's hand. In fact, a recent Bloomberg survey of economists found the Fed isn't expected to start raising its target rate until the third quarter of 2010.

The risks of getting the timing wrong are considerable. If the Fed abandons its zero-interest-rate stance too soon, it could ruin a recovery that is already undershooting economic forecasts, with gross domestic product growing just 2.2% in the third quarter, slower than the 2.8% expansion initially reported. Wait too long, though, and cheap money might inflate new asset bubbles of the kind that led to the credit crisis in the first place.

That's why Pierre Cailleteau, a managing director at Moody's Investors Service, believes 2010 will be "tumultuous" for government risk. "The key policy challenge facing advanced economies is to time the exit perfectly," he says. Perfection, unfortunately, isn't a hallmark of economic governance. |BW|

AMERICA'S SKYROCKETING PUBLIC DEBT



Data: Treasury Dept., Bloomberg

CHART BY ALBERTO MENA/BW

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NUMBERS

A SOBERING LOOK AT THE U.S. JOB MARKET

By Tara Kalwarski/Charts by David Foster

The U.S. unemployment rate hit a 26-year high in 2009, and most economists aren't expecting joblessness to return to its long-term average of 6% until well past 2011.

Outlook: Unemployment will remain high, says a survey of 57 economists

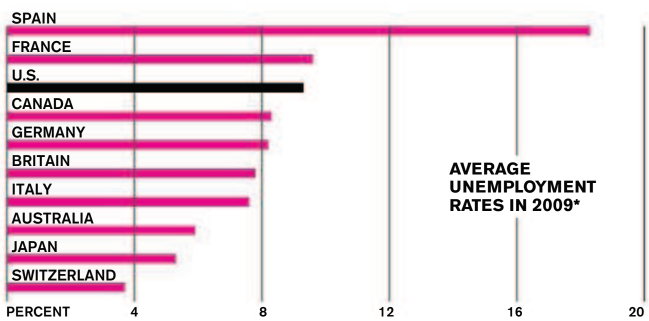
ECONOMISTS' PROJECTIONS OF THE U.S. UNEMPLOYMENT RATE*

	HIGH	LOW	MEDIAN
2010	10.8%	8.0%	10.0%
2011	10.7%	6.5%	9.3%

*As of Dec. 28

Data: Bloomberg

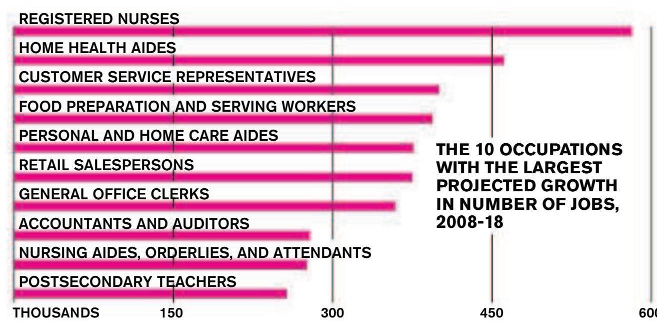
Elsewhere in the World: Most developed economies have lower unemployment rates than America's 10%.



Data: Bloomberg

*Forecasts as of Dec. 28

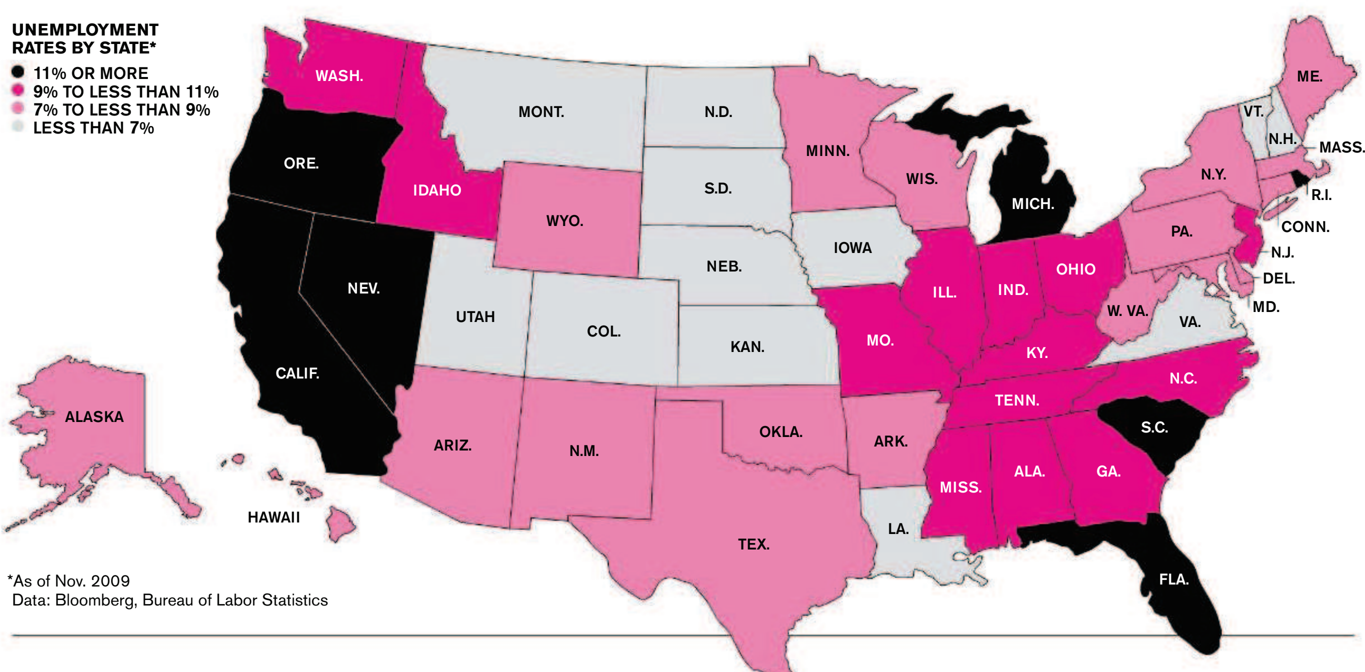
Rosier Forecasts: Health-care professions top the list of jobs expected to grow the most by 2018.



Data: Bureau of Labor Statistics

JOBLESSNESS ACROSS AMERICA

Unemployment recently fell in 26 states, but rates are still quite high.



*As of Nov. 2009

Data: Bloomberg, Bureau of Labor Statistics

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20 The IPO drought looks like it’s ending
22 Apple’s overlooked iPod touch

The Return of the Outsourced Job

To boost employment, local governments are wooing Indian companies such as Tata, Wipro, and Infosys. But the job gains are a drop in the bucket

By Mehul Srivastava and Moira Herbst

Ohio Governor Ted Strickland is quick to admit he doesn’t “particularly enjoy heights.” So why would he climb into a cherry picker to be lifted 40 feet in the air? To show off a 196,000-square-foot office park to executives from Tata Consultancy Services, India’s biggest tech company and a thriving part of the Tata Group conglomerate. To lure them to the park, Strickland threw in $19 million in tax credits and invited the TCS crew to a state dinner at the governor’s mansion. “The economy is difficult,” Strickland says. “I will go wherever I can to find jobs.”

TCS said yes, and in November, Strickland showed up at the sprawling wooded campus in the Cincinnati suburb of Milford for a ceremony to mark the hiring of the 300th employee at what has become the cornerstone of TCS’s North American efforts. Tata has hired some 250 graduates from Ohio State University, the University of Cincinnati, and other nearby schools. Soon the facility may employ as many as 1,000 Americans doing back-office and technology outsourcing for U.S. health-care companies and local governments.

With the economy growing again but unemployment stuck at double-digit levels, states and municipalities across the U.S. are scrambling to woo anyone with hiring plans—even if that means going hat in hand to the same bunch that has been responsible for hundreds of thousands of jobs going overseas. Dallas, Atlanta, Minneapolis, and Tallahassee have all been actively courting Indian tech outfits. Wipro Technologies in March inaugurated a center in Atlanta, which now has 350 employees—nearly 300 of them Americans, including senior managers recruited from U.S. tech rivals. Infosys Technologies is planning an operation in Dallas to target some of the projected $52 billion the U.S. government will spend on outsourcing work in 2010.

For the Indians, American facilities can mean more work on U.S. government and health-care projects—areas where laws prevent the transfer of data overseas. An on-the-ground strategy gives them access to local workers who can better understand cultural nuances. Plus it lets them compete better against American rivals, such as IBM and Accenture, which tend to win lucrative consulting contracts that hinge on solving complicated business problems on site, rather than simply writing computer code for cheap wages in India. “We need to become more efficient, more sophisticated,” says Sambuddha Deb, a Wipro vice-president who makes sure the company’s employees in India and overseas work seamlessly together. “It’s not just about setting up software factories” in India.

13,000

Number of Tata Consultancy Services employees in the U.S.

1,300

Number of Tata’s U.S. employees who are American

Data: Company reports



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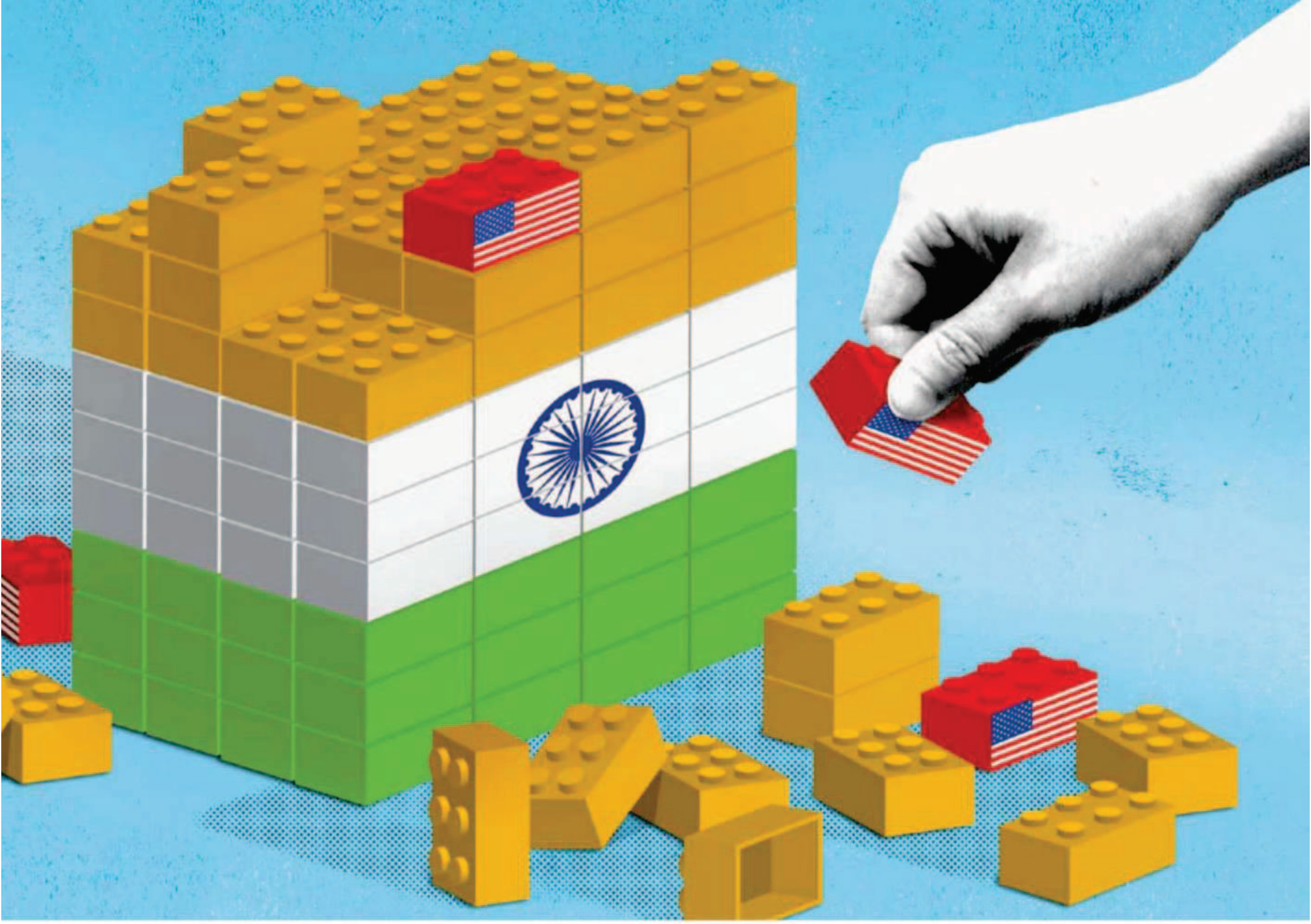


ILLUSTRATION BY GLUEKIT

Some critics say the new centers are little more than political cover and won't do much to boost employment in the U.S. "One reason they are doing this is for public relations," says Ron Hira, an expert on offshoring at Rochester Institute of Technology. "They want to send the message, 'We're creating jobs for Americans.'"

A LIMIT ON TEMPORARY VISAS

It's true that the jobs that Indian companies have created in the U.S. are a rounding error compared with their overall workforce. Even as it hired a few hundred American employees in 2009, TCS took on tens of thousands of newbies in India. And TCS has more than 11,000 Indians working in the U.S. on temporary visas, while Wipro has 7,000. That could change if a Senate bill introduced in April makes it through Congress. The measure would bar companies with more than 50 U.S.-based employees from using temporary visas for more than half their U.S. workforce, effectively forcing Indian IT companies to hire more Americans.

For Indian companies, hiring Americans is far more expensive than shipping work off to India. TCS staffers in Milford, for instance, earn more than $50,000 per year, vs. the $7,000-$8,000 that Indians doing similar work make in Bangalore. "Offshore outsourcers' wonderful profitability has largely been on the back of labor arbitrage," says Peter Bendor-Samuel, chief executive of Everest Group, a Dallas consulting firm that advises companies on outsourcing strategies. Those profits surely would take a hit if the Indian companies start bringing more Americans on board.

TCS had to delay opening its Ohio center for almost six months during the recession in the U.S. And Wipro says its Atlanta operation isn't yet profitable. Both say American facilities are unlikely to create huge numbers of new jobs in the U.S. soon. For several years, at least, the vast majority of work will continue to be done in India and other low-cost countries, according to Surya Kant, North America president for TCS. "But many [clients] want work to be done in the same time zone, and we want to be closer to our customers," Kant says. "Increasingly, we will move that work to centers like Cincinnati."

For Strickland and other officials in places where jobs in such industries as autos and steel have either disappeared or moved overseas, the new jobs—and the taxes they generate—are rare good news. "I certainly don't see it as consorting with the enemy," says Strickland, who ended up sharing a table with Tata Group Chairman Ratan Tata and India's Commerce Minister Anand Sharma at the Nov. 25 White House State Dinner for Indian Prime Minister Manmohan Singh. "These are good, solid jobs," adds the governor. "Jobs that we feel will be long-term, and that we hope will increase in numbers." | BW |

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Measuring the Gas Without the Hot Air

Declared emissions are out of whack with the amounts researchers have observed

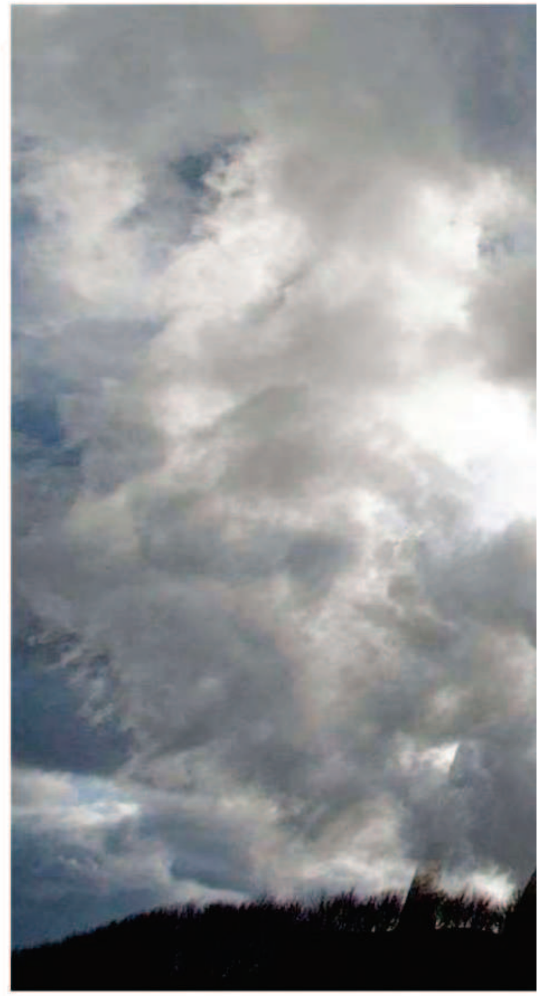
By John Carey

As the world gets serious about fighting climate change, a huge question looms: Are countries and companies really reducing their greenhouse gas emissions as much as they claim? The answer is crucial not just for the planet, but for business. The tighter the limits on emissions, the higher the price companies have to pay to pollute—and, conversely, the more profits some companies will reap by releasing less gas and monetizing the reductions under the umbrella of cap and trade. Considering the billions of dollars at stake, "can we really trust what's reported?" asks Pieter P. Tans, senior scientist at the National Oceanic & Atmospheric Administration's Earth System Research Laboratory in Boulder, Colo.

Tans and many other researchers worry that the answer is no. Typically, the emissions of a company or nation are calculated from the bottom up—sort of like figuring out what you weigh by looking at what you eat. Start with data on, say, the amount of coal shoveled into a power plant or the millions of barrels of crude oil going into refineries. Then estimate out how much carbon dioxide is produced when the coal is burned, or when the oil is turned into gasoline to power cars.

Such calculations may appear precise; so did the numbers from Enron and its accountants at Arthur Andersen, notes Ray Weiss, distinguished professor of geochemistry at the Scripps Institution of Oceanography. The original data may be wrong, or the assumptions flawed. Relying on self-reported emissions and paper audits "seems to be asking for misdeclaration or even fraud, at all levels from local emitter to great nation," says geologist Euan Nisbet at the University of London, who heads the European Union's methane monitoring program.

Consider sulfur hexafluoride (SF_6), a man-made gas used to insulate transformers and other electrical equipment. It's a potent greenhouse gas, 23,900 times more powerful than CO_2. That means under cap and trade, the price you pay for the right to emit one ton of SF_6 is also 23,900 higher than the price of CO_2—which is now $18 per metric ton in Europe. Under the U.N. Framework Convention on Climate Change, industrialized countries report how much of the stuff they're pumping into the atmosphere. They calculate emissions using information on how much SF_6 manufacturers sell to customers and estimates of how much escapes to the atmosphere from devices or production facilities. If you believe the reports, emissions of SF_6 are declining.



WOLFGANG VON BRAUCHITSCH/BLOOMBERG

Blowing smoke: A coal-burning power plant near Bergheim, Germany

The reports are wrong. When researchers actually measure the chemical in the air, they find it in quantities more than three times greater than what the reported amounts would indicate—and levels are increasing, not declining. The findings were a surprise, says NOAA's Tans: "It wasn't on anyone's radar screen."

Why the discrepancy? No one knows for sure. Some of the blame goes to Chi-

THE GREENHOUSE GAS GAP

Companies and countries report their emissions but the disclosed amounts often don't add up to what's actually in the air

SULFUR HEXAFLUORIDE
Potent man-made greenhouse gas used as an insulator in switches and transformers on the electrical grid. Reported emissions are declining, but amounts in the atmosphere are going up.

METHANE
Emitted by everything from peat bogs to landfills, cattle ranches, and coal mines. Measurements show atmospheric levels can be higher than the sum of reported emissions.

CARBON DIOXIDE
Comes from natural sources and burning fossil fuels. Reported and actual levels are now fairly close, but researchers worry that putting a high price on carbon could be an incentive to under-report.

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na, which hasn't been required to report emissions and which has balked at submitting to international verification. But the gap is too large to be explained just by emissions from developing countries. Another probable cause is under-reported emissions in the U.S. While utilities and other companies recycle the gas by sucking it out of aging equipment, more of it may escape than workers realize or report. "We have a very big issue, not just internationally but also domestically," says Lukas Rothlisberger, CEO of DILO, a leader in SF_6 maintenance and recycling equipment: "Some of the numbers used, in my humble opinion, are very flawed."

It's a cautionary tale. "If we can cheat on something like sulfur hexafluoride, what happens when carbon dioxide is worth $50 or $100 per ton?" asks Michael R. Woelk, CEO of Picarro, a measuring instruments company in Sunnyvale, Calif. SF_6 is not unique. Scripps' Weiss has found more than three times as much nitrogen trifluoride (NF_3) in the atmosphere as he expected. NF_3 is a chemical used in flat panel manufacturing—and is a powerful greenhouse gas. Methane measurements reveal that some reported emissions are low compared with

"MONITORING IS SCIENCE'S CINDERELLA, UNLOVED AND POORLY PAID," SAYS ONE CLIMATE RESEARCHER

atmospheric levels, and that purported reductions from capturing methane at landfills are vastly overstated. The track record for estimating carbon dioxide emissions is better, says Tans, "but if emissions cost a large amount of money, I'm not sure that will be the case."

There may be a solution, researchers say: Step up efforts to measure greenhouse gases in the atmosphere, both globally and locally. In the past few years, companies such as Picarro, Los Gatos Research, and LI-COR have developed instruments capable of continuously monitoring concentrations of trace gases in the air. That saves scientists the chore of collecting samples in flasks and bringing them back to the lab for analysis. "The new instruments have been revolutionary, from a science perspective," says biologist Joe von Fischer of Colorado State University.

Von Fischer, who has no financial stake in any of the measuring equipment companies, has used such instruments to find hotspots of methane wafting from the Alaskan tundra. This is helping to address the question of whether Arctic warming will speed up such emissions. Others are monitoring methane from cows and termite mounds, spotting CO_2 plumes from rush hour traffic, or watching to see if CO_2 pumped into the ground will stay there or leak out. "There's only one way to validate what's really happening, and that's to measure it," says Doug Baer, president of Los Gatos Research in Mountain View, Calif.

Scientists' current efforts only scratch the surface of what's needed, however. NOAA's Tans figures a system of instruments capable of keeping emissions reporting honest would be more than 10 times larger than today's monitoring networks and would cost $100 million or more. Right now, that's a tough sell. "Monitoring is science's Cinderella, unloved and poorly paid," laments Nisbet.

That could change as emissions become more valuable, upping the pressure to report them more accurately. Another hopeful development occurred at the Copenhagen climate talks in December, where developing countries agreed to some international verification of their emissions cuts. Such oversight is essential to prevent greenhouse gas emissions from becoming a house of mirrors. Says Doug Rotman, program director at Lawrence Livermore National Laboratory, "To get top-down monitoring will be a struggle, but it is really what we have to do." |BW| *—with Mark Scott in London*

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IPOs: Big Names, Modest Interest

2010 could see Facebook, Twitter, and more go public. But is the public ready?

By Tim Mullaney

Sam Colella remembers the exact day the initial public offering market fell apart. The venture capitalist and chairman of the biotech company Fluidigm was in Switzerland in September 2008 when the company's investment banker called to say Lehman Brothers had failed. So unnerved was the banker, who worked for Morgan Stanley, that he stuttered out the news. Days later, Fluidigm canceled its offering, setting off the longest IPO drought for startups in 40 years.

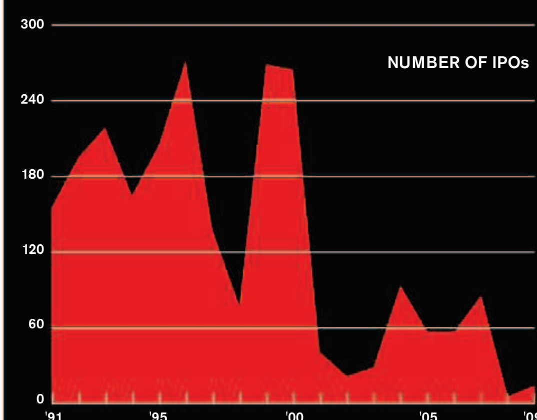
That drought is ending. The number of startup companies going public in the upcoming year is expected to increase substantially from the 13 offerings in 2009, although the precise number is a matter of much debate. Venture capitalists predict offerings will double, to 26, according to a survey by the National Venture Capital Assn. of 325 members. Other experts believe the number may go beyond 50. "You could see 80 to 90 [companies] spend the million dollars to file, and north of 50 go public," says Tony Perkins, founder of tech conference promoter AlwaysOn Network. Fluidigm plans to be one of them, since Colella thinks investors are ready to take risks again.

Sandy Miller, a partner at Institutional Venture Partners in Menlo Park, Calif., says the number of profitable, private technology companies is probably at or near a record. Partners at IVP, New Enterprise Associates (NEA), and other VC firms say they have five or six viable candidates each, most with $100 million in annual sales or more. "These companies are 7 to 10 years old, and they've passed the test of the economy," says Dick Kramlich, a co-founder of NEA in Menlo Park.

Skeptics counter that no one really knows whether investors are ready to open their wallets for fledgling companies. Deepak Kamra, a partner at Canaan Partners, points out that VCs have done little research into whether institutional investors want more stock in startups. "We know about supply, but not about demand," he says. Kamra says investors' appetite for risk will depend in large part on the overall stock market. "Tell me how the Nasdaq does and I'll tell you how many IPOs," he says.

IPOs BY THE NUMBERS

Initial public offerings by startups have crashed the past two years, but venture capitalists are hoping the action will heat up again



Data: National Venture Capital Assn.

"THESE COMPANIES ARE 7 TO 10 YEARS OLD, AND THEY'VE PASSED THE TEST OF THE ECONOMY," SAYS ONE VENTURE CAPITALIST

Over the last two months, 16 companies have filed to go public. They include two well-known cleantech companies, solar panel maker Solyndra and Codexis, which makes enzymes for cellulosic ethanol. QuinStreet and ReachLocal, fast-growing and profitable Web advertising companies, have also filed offering documents with the Securities & Exchange Commission. Sunnyvale (Calif.)-based Telegent Systems, which makes chips to deliver TV service on mobile phone, may be one of the bigger offerings, after filing to raise as much as $250 million.

Next year is also likely to include offerings by several marquee names. Facebook and Twitter are IPO candidates for 2010. Electric car maker Tesla may try to go public. And Silver Spring Networks, which develops smart grid technology for utilities, could test investors' interest, though Warren Jenson, chief financial officer for Silver Spring, says the company is in "no hurry" to go public.

Still, the recovery will be far from a new boom. A market with 26 deals, as the NVCA survey predicted, would resemble the depths of the Internet bust earlier this decade. The 22 startup deals in 2002 and 29 in 2003 were the bottom of the post-bubble market, according to the association. "It's higher than we've had, but still pretty abysmal," says Mark G. Heesen, president of the NVCA.

The real recovery for IPOs may have to wait until 2011. NEA partner Scott Sandell believes investors want to have a better understanding of the economic recovery and companies' ability to manage through tough times before they make big bets on startups. "If the market stays open until 2011, the numbers will go up a lot," says Sandell. "A lot more [companies] will be ready." |BW|

CHART BY ALBERTO MENA/BW

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All iWant for Christmas...

While Apple's iPhone grabs headlines, the cheaper iPod touch keeps gaining devoted fans

By Peter Burrows

Ever since Apple introduced the iPhone in the summer of 2007, it has been hailed as one of the most revolutionary products in tech history. By comparison, the iPod touch, which has all the iPhone's features without the cell phone, has been downright publicity-starved.

But this holiday season, it seems the thinner, cheaper device may be Apple's breakout hit. While actual sales data are not yet available, Broadpoint AmTech analyst Brian Marshall figures iPod touch sales soared more than 100%, to 7.2 million, in the final quarter of 2009, while iPhone sales rose 53%, to 11.3 million.

For further evidence of an iPod touch boom, check out the data from Flurry, which makes analytics software embedded into thousands of mobile applications. While the number of apps downloaded onto iPhones rose 29% from Dec. 24 to Dec. 25, downloads onto iPod touches skyrocketed by more than 300%—and surpassed the iPhone for at least that day. "It wasn't just that the iPod touch barely squeaked by," says Flurry Vice-President Peter Farago. "It blew the doors off the iPhone—and overnight."

The iPod touch's popularity can do pretty much anything an iPhone can do, and for a lot less money. It features the same slick multi-touch interface and can run almost all the 100,000-plus programs in Apple's App store. The main difference is that the iPod touch does not work over cellular networks, so owners must be within striking distance of a Wi-Fi hotspot to go online or download apps. But Wi-Fi is available in most homes, offices, airports, and coffee joints, either for free or for a few bucks—but it costs nowhere near the monthly $100 of an AT&T contract.

To some extent, a spike in iPod touch sales has become an annual yuletide ritual. Given its price—ranging from $180 to $399, depending on memory—and ability to run apps, the device has taken the portable gaming market by storm. Carol Cirulli Lanham, a mother of two from Dallas, says she bought an iPod touch for her 12-year-old son "because I would not want to pay for the monthly contract fee. Plus, I think an iPhone at this age would really make him a spoiled brat."

SOME USERS ARE OPTING FOR THE TOUCH BECAUSE THEY FEAR COMMITTING TO AT&T, THE iPHONE'S SERVICE PROVIDER



COURTESY OF APPLE

This year, iPod touch sales may be getting an extra boost from the travails of AT&T, the exclusive carrier of the iPhone in the U.S. Because of Ma Bell's network problems, including frequent dropped calls and spotty Net access in cities such as New York and San Francisco, many consumers are opting to carry a new iPod touch along with their old cell phone rather than rely on an iPhone. "I just couldn't put my trust in AT&T," says Scott Gingold, the owner of a market research firm based in New York City. Instead, Gingold carries a BlackBerry that he uses for email and making calls, while he relies on the iPod touch for running apps and going online.

Folks like Gingold may also be tempted by Apple's much-rumored tablet device. The company would not comment for this story or confirm talk that the gadget will be unveiled at a Jan. 26 event. But sources expect the tablet device to be roughly three times the size of an iPhone, making it well-suited for playing games, running apps, and reading e-books or online newspapers. The device may also rely on Wi-Fi, allowing Apple to further distance itself from AT&T's service woes.

Still, the question remains as to whether the iPod touch can stave off a long-term decline in iPod sales. Even raging bulls such as Broadpoint's Marshall, who on Dec. 28 raised his target price for Apple stock to a stratospheric 260 from its current all-time high of 209, expects overall sales of iPods to tail off in the years ahead, as their features are incorporated into smart phones.

But the worst-case scenario for Apple doesn't look so bad. Usually, maturing products suffer not only from falling unit sales but falling prices. That's not the case with iPods. The iPod touch is the best-selling MP3 player on Amazon.com, beating out the $59 iPod shuffle. And while it remains to be seen how long the holiday boom in iPod touch sales will last, Flurry's Farago believes it won't be just a one-quarter blip. "What we know for sure is that a huge new batch of iPod touch users was injected into the system." |BW|

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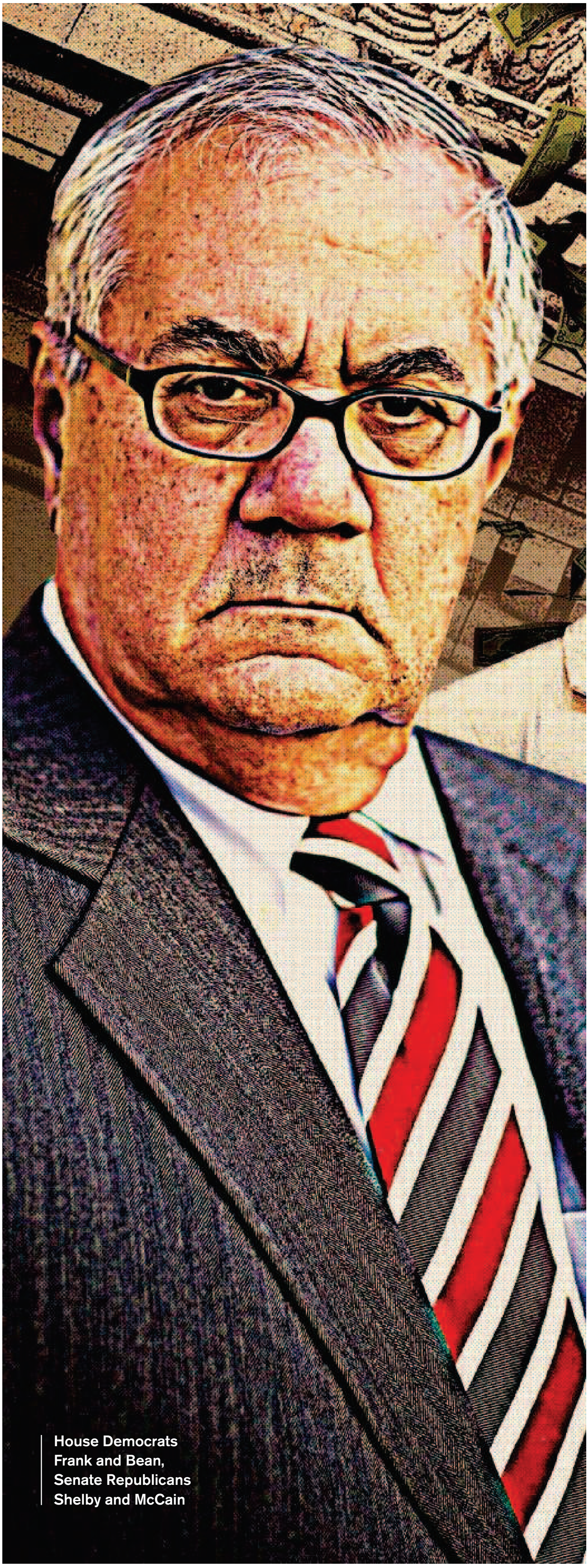
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NOT SO RADICAL REFORM

By Alison Vekshin and Dawn Kopecki

Illustration by Sean McCabe

How New Democrats and Wall Street are watering down financial regulation in Congress



House Democrats Frank and Bean, Senate Republicans Shelby and McCain

BROOKS KRAFT/CORBIS; EVAN VUCCI/AP PHOTO; JOSHUA ROBERTS/BLOOMBERG NEWS; JIM YOUNG/REUTERS

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"I have nothing to say except I know how Britney Spears feels," said Representative Barney Frank on Sept. 27, 2008, after yet another day in which a pack of journalists followed his every move. In the frenzied early reckoning of the financial crisis, Frank, the 15-term Massachusetts Democrat known for being the second openly gay member of Congress—and the first member for reporters to hit up for a great quote—made the rare Washington leap from colorful supporting player to full-fledged protagonist: As the chairman of the House Financial Services Committee, the banking industry was a sick patient at his feet. Main Street demanded change. Wall Street feared it was coming. And Frank promised to deliver. "You need a new tool kit for new phenomena, and our job next year is to develop that toolkit," he said in an interview with Bloomberg News.

Frank's legislative agenda was ambitious. He pushed for the creation of a council of regulators to oversee systemic risk; the establishment of a national consumer protection agency; stricter standards for hedge funds, private equity firms, and credit-rating agencies.



In September Obama scolded Wall Street for "reckless behavior"

The federal government certainly went to extraordinary lengths to forestall a depression and to save the banking system. Congress passed the $700 billion Troubled Asset Relief Program in 2008. Fannie Mae and Freddie Mac, the giant government-sponsored enterprises that are the backbone of America's housing industry, were essentially nationalized. The U.S. Federal Reserve and the Treasury presided over the restructuring of Wall Street, including the bankruptcy of Lehman Brothers, the sale of Bear Stearns, and the conversion of Morgan Stanley and Goldman Sachs into bank holding companies. Meanwhile the government, during the worst of the panic, seemed to roll out a new relief program every week, including a rescue package of American International Group. (Subsequently it has forced the brief bankruptcies of General Motors and Chrysler.) Some of these measures carried short-term stipulations such as compensation limits that the financial institutions, and the well-paid executives who run them, don't like.

But rescuing the system is hardly the same thing as reforming it, and a diverse chorus of voices worries that, with the stock market's recovery and the last of the big banks poised to leave TARP, the moment for real change has been squandered. It's not only a concern in the U.S.: In Europe regulators and policymakers so far haven't enacted a single proposal that would overhaul the financial system. "Meaningful regulatory change is urgent now because this is the window of opportunity," warns Simon Johnson, a professor of entrepreneurship at Massachusetts Institute of Technology and a former International Monetary Fund economist. "If that window closes, we're asking for trouble." Paul Volcker, chairman of President Barack Obama's Economic Recovery Advisory Board and former chairman of the Federal Reserve, recently visited nine cities in five countries delivering speeches warning that bankers and regulators around the world "have not come anywhere close to responding with necessary vigor." Volcker wants lawmakers to bust up the big banks. Since the crisis began, the institutions deemed "too big to fail" have only gotten bigger; at the end of 2008 the world's 10 largest banks had 26% of the assets of the top 1,500 banks, up from 18% in 1999.

So what happened to Frank's initial fervor? The stock market recovery–the Standard & Poor's 500-stock index is up 67% since the March 2009 low–drained some anger from the debate, and after months of haggling over health care, legislators heard from their constituents that regulation was no longer a word with magic healing powers.

More important, Frank, House Speaker Nancy Pelosi, and other left-leaning Democrats have had to deal with the New Democrat Coalition, a moderate group inside the party that shares many of the values associated with Bill Clinton and the Democratic Leadership Council, which was founded 25 years ago in the belief that Democrats couldn't win elections without a strong moderate platform.

In the House of Representatives, where the debate on regulatory reform started, the New Democrat Coalition has 68 fiscally conservative, pro-business members who fill 15 of the party's 42 seats on the House Financial Services Committee. And with just a 38-member voting majority over Republicans (who often vote as a block in the House), Frank and Pelosi can't push legislation through without the New Democrats' support. "We're pro-growth, innovative Democrats with real-life experience," said New York Representative Joseph Crowley, the Coalition's chairman. "Many of us come out of the business world." The group's growing importance isn't lost on the President. After traveling to Manhattan in September to rally support for financial regulation, Obama invited a couple of members, including Crowley, to fly back with him to Washington on Air Force One.

The New Democrats' ties to Wall Street are strong. Jim Himes, a first-term congressman from Connecticut, is a former Goldman Sachs investment banker. Representative Mike McMahon represents a large constituency of Wall Street employees in Staten Island and Brooklyn. Crowley likes to point out that workers in his Bronx and Queens district sweep the floors, drive the cars, and pull the beer taps for Wall Street traders. Since the start of the 2008 election cycle, the financial industry has donated $24.9 million to members of the New Democrats, some 14% of the total funds the lawmakers have collected, according to the Center for Responsive Politics. Representative Melissa Bean of Illinois, who has led the

LARRY DOWNING/REUTERS

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Coalition's efforts on regulatory reform, was the top beneficiary, with donations of $1.4 million.

While the House Financial Services Committee was tweaking the reform bill proposed by the Obama Administration this summer, the New Democrats pushed back on key regulatory issues. One of the biggest: derivatives, the complex financial instruments that helped spark the global financial crisis. Most derivatives are traded in murky over-the-counter deals. The Administration wanted to push some of them onto regulated trading platforms. But that would have crimped one of Wall Street's most lucrative businesses: The top five U.S. commercial banks, including JPMorgan Chase, Goldman Sachs, and Bank of America, were on track through the second quarter to earn more than $35 billion in 2009 trading unregulated derivative contracts, according to a review of company filings with the Federal Reserve and people familiar with the banks' income sources. So JPMorgan, along with Goldman Sachs and Credit Suisse, lobbied McMahon, Bean, and other New Democrats to temper the proposed rules.

PRO-REGULATION FORCES BACKED DOWN ON A BILL REGULATING DERIVATIVES AFTER RECEIVING A LETTER FROM THREE LARGE BUSINESS TRADE ORGANIZATIONS

The New Democrats in turn reached out to Frank. As Obama vowed in the Sept. 14 speech in New York's Federal Hall to correct "reckless behavior" on Wall Street, McMahon and Frank sat together in the audience and discussed the Administration's proposed rules. The freshman congressman told Frank he was worried that Obama's derivatives plan would penalize a wide swath of U.S. corporations, not just banks, and would push jobs overseas. McMahon said Frank agreed it was important to protect so-called end-users, the corporations that rely on derivatives to hedge against fluctuations in foreign currencies, interest rates, and commodity prices. "He said we'd be working together on this," McMahon told Bloomberg News. "We never had a philosophical difference."

Two weeks later, a half-dozen New Democrats pressed Treasury Secretary Timothy Geithner to exempt end-users from the rules. "We were in the weeds on the derivatives bill," said Himes of the meeting, which was also attended by Bean, Crowley, and McMahon. Meanwhile, business trade organizations were rallying around the derivatives issue. In August three large trade organizations—the National Association of Manufacturers, the U.S. Chamber of Commerce, and the Business Roundtable—formed the Coalition for Derivatives End Users. The 171-member group, which includes MillerCoors, IBM, Apple, and Johnson & Johnson (and no financial companies), sent a letter to Congress on Oct. 2 saying some reform proposals "place an extraordinary burden on end-users of derivatives."

The pro-regulation forces backed down. Under the House bill that passed in December, banks won't have to trade stan-

WATERED-DOWN REFORMS

The House proposal looks weaker than the plan the President proposed this summer.

	WHAT'S ON THE TABLE	WHAT'S OFF
Consumer Protection	The House voted to create the Consumer Financial Protection Agency, which would oversee mortgages, credit cards, and other consumer products. The Senate may consider a similar measure.	Real estate agents, auto dealers, and other non-financial companies were exempted from the purview of the agency.
Executive Pay	The House bill requires that all public companies let shareholders participate in a nonbinding vote on compensation. It also allows regulators to ban incentive pay that they believe encourages excessive risk-taking.	The only formal caps on compensation are under TARP.
Derivatives	Under the House rules, banks that trade standard derivatives outside of a regulated trading platform will have to report the deals to regulators.	Policymakers won't force standard transactions onto trading platforms and clearinghouses where regulators can see positions and prices. Airlines, energy companies, and others that use the complex financial instruments to protect against operational risk are exempted from many of the rules.
Asset-Backed Securities	To make sure banks have skin in the game, lawmakers want lenders to hold capital against a portion of the bundled loans they sell off to investors.	Banks would have to account for only 5% of the investment risk on their books, as opposed to the 10% Frank originally proposed.

Data: *Bloomberg BusinessWeek*

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dardized derivatives on regulated trading platforms, although they will have to report the deals to regulators. And airlines, energy companies, hedge funds, and other end-users are exempted from many of the rules. "There are some things in there that are irritating to the Street," says Chris Whalen, managing director of Institutional Risk Analytics, a research firm in Torrance, Calif. "But compared with what we thought we were going to get over the summer, it's night and day." In an interview with Bloomberg TV on Dec. 11, Frank called the end-user exemption a "small dent" in his bill. "If you take the total number of derivatives done by Caterpillar, Boeing, John Deere, Cargill, and a number of other manufacturers, you're not going to create a systematic problem," says Steven Adamske, a spokesman for the House Financial Services Committee.

UNDER THE INFLUENCE OF NEW DEMOCRATS, THE HOUSE REJECTED AN AMENDMENT THAT WOULD HAVE GIVEN JUDGES THE POWER TO SOFTEN TERMS FOR BANKRUPT HOMEOWNERS

At the last minute Bean and her fellow New Democrats also delayed debate on the House reform bill to negotiate more changes. The proposed legislation to create a Consumer Financial Protection Agency allowed states to apply tougher rules to safeguard consumers; national banks sought to block the measure. On Dec. 7, Bean proposed an amendment to give federal regulators more discretion to override state consumer protection laws than what was initially proposed. Lawmakers held discussions on Dec. 9, the day of the debate, on whether or not to include Bean's provisions. In the early evening, House Majority Leader Steny Hoyer shuttled between Frank and other top lawmakers in one office and Bean and Treasury officials in another. After an hour, Frank emerged and told reporters that a version of Bean's proposal would be in the final bill. "Some of the banks had a successful run at lobbying the New Dems," Frank said in a Dec. 10 interview. Bean says she isn't carrying water for Wall Street, pointing to her support for the Consumer Financial Protection Agency that the industry didn't like. "I think we differ," she says.

The New Democrats' fingerprints are all over the final House bill. Lawmakers rejected a mortgage "cram-down" amendment, which would have given federal judges the power to extend loan terms, lower interest rates, and cut principal for bankrupt homeowners. Although lawmakers ultimately voted to create a consumer protection agency, the New Democrats succeeded in stripping the proposal of some components. Under the bill, real estate agents, auto dealers, and other nonfinancial companies won't fall under the purview of the agency. And the largest banks won't have to offer plain-vanilla credit-card and mortgage products.

While the House came to a consensus that deemphasized some reforms, the Senate still can't agree. Senators Christopher Dodd (D-Conn.) and Richard Shelby (Ala.), the ranking Republican on the Senate Banking Committee, tried for months to hammer out a bill, but Shelby balked at some of the components. Unable to find a compromise, Dodd decided in November

WHY THE SEC KEEPS BACKPEDALING

New Chairman Schapiro could be caving in to business pressure

By Jesse Westbrook

In the wake of Bernie Madoff's $65 billion Ponzi scheme, Mary L. Schapiro, the new chairman of the Securities & Exchange Commission, said she wanted to show that her agency was cracking down. So in May she proposed that almost 10,000 money managers undergo surprise inspections to make sure they weren't ripping off clients. "Investors are looking to the SEC to assure the safekeeping of their assets," she said. "We cannot let them down."

On Dec. 16, however, Schapiro settled for a less sweeping measure. She and four other SEC commissioners approved a rule requiring unannounced audits for only about 1,600 fund managers, 83% fewer than under the original proposal. The downsized inspections came after executives of fund companies, including T. Rowe Price Group, met with Schapiro, and representatives of Legg Mason met with another commissioner, SEC records show.

That's just one of several Schapiro measures—announced with fanfare as a way to protect investors and boost confidence—that were later scaled back or delayed. In August she bought herself more time on a proposal to rein in short-sellers, traders who bet the prices of selected stocks will fall. The move came after lobbying by hedge funds. In October, Schapiro put off plans to give investors more power to decide who sits on corporate boards. "You get zero points in history for what you proposed," says former SEC Chairman Richard C. Breeden, who now runs a hedge fund that has tried to oust directors at companies he believes are underperforming. "You get points for what you get over the goal line." Schapiro says the SEC is doing all it can. "We just don't have the capacity to move any faster," she says. "I've been driving people very, very hard in this building." Former SEC officials say a flurry of new rules, including still-

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to offer up his own proposal without Republican support.

Almost immediately Republicans began to trash the legislation. With discussions at a standstill in November, Dodd opted for a fresh approach. The Banking Committee formed four teams of committee members—with one Republican and one Democrat on each team—to work out a bipartisan compromise bill. They're hashing out everything from new rules for the credit rating agencies to possible limits on executive compensation. "These talks have been extremely productive with members providing great insight," Dodd and Shelby said in a Dec. 23 press release. A bill might not be ready until the spring, according to Shelby. "Wall Street is probably happy with the slowness of the process," says Paul Miller, an analyst with investment bank FBR Capital Markets, "because the slower the process, the more you can drag it out and water it down."

Meanwhile, the onslaught from the financial services industry continues. The U.S. Chamber of Commerce has focused on the Consumer Financial Protection Agency, a possible component of the bill that Dodd is trying to craft. The lobbying group launched a television advertising campaign titled "No Sleep" to illustrate the sleepless nights of business owners overwhelmed by regulation, and created a Web site to stoke opposition. The campaign follows a grassroots effort in August to block the formation of the agency; back then bankers visited lawmakers in 36 states and wrote more than 75,000 letters to Congress, according to David Hirschmann, head of the Center for Capital Markets Competitiveness, a Chamber-led initiative focused on financial regulation.

It's possible public anger could yet fuel a regulatory push. Banks will start giving bonuses to their employees in January; the bigger the payouts, the bigger the potential outrage. Senators John McCain (R-Ariz.) and Maria Cantwell (D-Wash.) on Dec. 16 proposed a bill that would reinstate the 1933 Glass-Steagall Act, which separated commercial banking from investment banking until its partial repeal in 1999. "Wall Street firms have recovered nicely and profits are soaring," McCain said in a press conference, while "Main Street is suffering terribly." The same day Representative Maurice Hinchey (D-N.Y.) put forth similar legislation in the House. But even he thinks it's a long shot: "There's a lot of pressure coming from the big banks to prevent this kind of thing from happening."

A failure wouldn't surprise frustrated lawmakers disappointed by the turn in Washington. "My greatest fear for the last year has been an economic collapse," says Representative Brad Miller (D-N.C), who sits on Frank's House Financial Services Committee. "My second greatest fear was that the economy would stabilize and the financial industry would have the clout to defeat the fundamental reforms that our nation desperately needs. My greatest fear seems less likely ... but my second greatest fear seems more likely every day." | BW |

—With Gadi Dechter and Robert Schmidt in Washington and Michael J. Moore in New York



Schapiro proposes reforms but tends to postpone action

JOSHUA ROBERTS/BLOOMBERG NEWS

unfinished proposals aimed at tightening supervision of credit rating companies and money market funds, have helped rehabilitate the agency.

Schapiro, 54, has spent more than two decades in financial regulation. She first served as a staff attorney at the Commodity Futures Trading Commission, followed by stints as an SEC commissioner, chairman of the CFTC, and then CEO of the Financial Industry Regulatory Authority, a Wall Street-funded overseer of brokerages. Edward Fleischman, a former SEC commissioner who is now a senior counsel at the Linklaters law firm in New York, says Schapiro "doesn't appear to be a steamroller who says, 'I made the proposal, so it must be right.'"

In May, Schapiro proposed giving shareholders more power over corporate boards by making it easier to wage proxy fights. Long a goal of investor advocates, the proposal would have allowed some shareholders to nominate board members directly on corporate ballots rather than pay to print and mail a second proxy statement. The U.S. Chamber of Commerce called the SEC plan "unworkable" and got ready to file a lawsuit. By September, Schapiro's staff was telling investors the proxy-access rule wouldn't be in place for 2010 director elections. In October the SEC said the rule would be delayed.

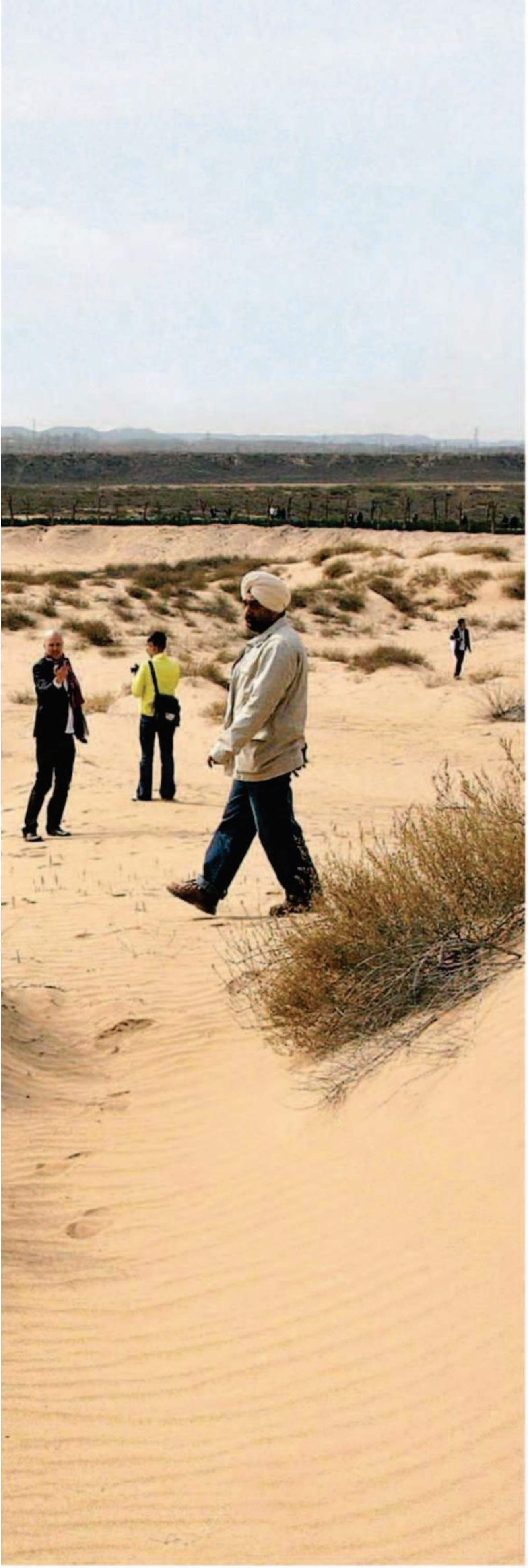
Schapiro's agenda has also been driven by political pressure, says James J. Angel, a finance professor at Georgetown University who has advised stock exchanges. Democrat Barney Frank, chairman of the House Financial Services Committee—one of the SEC's overseers—said at a Mar. 10 press conference that after speaking with the SEC boss, he was "hopeful" that "within a month" she would reinstate the uptick rule; it requires that investors wait for a stock to rise before betting against it, which prevents short-sellers from piling on. In April, Schapiro proposed the rule—only to postpone it.

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To design villas for the new center of Ordos city, architects sized up a stretch of Inner Mongolian desert in 2008

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DOUG KANTER/THE NEW YORK TIMES/REDUX

MANIA ON THE MAINLAND

Think the U.S. real estate bubble was bad? China's could be worse

By Dexter Roberts



BEIJING

Li Nan has real estate fever. A 27-year-old steel trader at China Minmetals, a state-owned commodities company, Li lives with his parents in a cramped 700-sq.-ft. apartment in west Beijing. Li originally planned to buy his own place when he got married, but after watching Beijing real estate prices soar, he has been spending all his free time searching for an apartment. If he finds the right place—preferably a two-bedroom in the historic Dongcheng quarter, near the city center—he hopes to buy immediately. Act now, he figures, or live with Mom and Dad forever. In the last 12 months such apartments have doubled or tripled in price, to about $400 per square foot. "This year they'll be even higher," says Li.

Millions of Chinese are pursuing property with a zeal once typical of house-happy Americans. Some Chinese are plunking down wads of cash for homes: Others are taking out mortgages at record levels. Developers are snapping up land for luxury high-rises and villas, and the banks are eagerly funding them. Some local officials are even building towns from scratch in the desert, certain that demand won't flag. And if families can swing it, they buy two apartments—one to live in, one to flip when prices jump further.

And jump they have. In Shanghai,



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prices for high-end real estate were up 54% through September, to $500 per square foot. In November alone, housing prices in 70 major cities rose 5.7%, while housing starts nationwide rose a staggering 194%.

The real estate rush is fueling fears of a bubble that could burst later in 2010, devastating homeowners, banks, developers, stock markets, and local governments. "Once the bubble pops, our economic growth will stop," warns Yi Xianrong, a researcher at the Chinese Academy of Social Sciences' Finance Research Center. On Dec. 27, China Premier Wen Jiabao told news agency Xinhua that "property prices have risen too quickly." He pledged a crackdown on speculators.

UNAFFORDABLE PRICES

Despite parallels with other bubble markets, the China bubble is not quite so easy to understand. In some places, demand for upper middle class housing is so hot it can't be satisfied. In others, speculators keep driving up prices for land, luxury apartments, and villas even though local rents are actually dropping because tenants are scarce. What's clear is that the bubble is inflating at the rich end, while little low-cost housing gets built for middle and low-income Chinese. In Beijing's Chaoyang district—which represents a third of all residential property deals in the capital—homes now sell for an average of nearly $300 per square foot. That means a typical 1,000-sq.-ft. apartment costs about 80 times the average annual income of the city's residents. Koyo Ozeki, an analyst at U.S. investment manager Pimco, estimates that only 10% of residential sales in China are for the mass market. Developers find the margins in high-end housing much fatter than returns from building ordinary homes.

How did this bubble get going? Low interest rates, official encouragement of bank lending, and then Beijing's half-trillion-dollar stimulus plan all made funds readily available. City and provincial governments have been gladly cooperating with developers: Economists estimate that half of all local government revenue comes from selling state-owned land. Chinese consumers, fearing inflation will return and outstrip the tiny interest they earn on their savings, have pursued property ever more aggressively.

Companies in the chemical, steel, textile, and shoe industries have started up property divisions too: The chance of a quick return is much higher than in their primary business. "When you sit down with a table of businessmen, the story is usually how they got lucky from a piece of land," says Andy Xie, an independent economist who once worked in Hong Kong as Morgan Stanley's top Asia analyst. "No one talks about their factories making money these days."

Ordos' new housing now mostly lies empty, waiting for buyers

HOMES BUILT ON SAND

Newly wealthy towns are playing the game with a vengeance. Ordos is a city of 1.3 million in China's Inner Mongolia region. It has gotten rich from the discovery of a big coal seam nearby. An emerging generation of tycoons, developers, and local officials will go to any length to invent a modern Ordos. So 16 miles from the old town, a new civic center is emerging from the desert that could easily pass for the capital of a midsize country. An enormous complex houses City Hall and the local Communist Party headquarters, each 11 stories tall with sweeping circular driveways. Nearby loom a fortress-like opera house and a slate-gray, modernist public library. Thousands of villas and apartment towers stretch into the distance, all built by local developers in the hope that Ordos' recently prosperous will buy the places to be near the new center of power. Workers get bused daily to the new city hall, but the housing is still largely unoccupied. "Why would anyone go there?" asks Zhao Hailin, a street artist in the old town. "It's a city of empty buildings." (Ordos officials would not comment for this story.)

CHINESE WHO HAVE THE MONEY ARE DESPERATELY SNAPPING UP APARTMENTS FOR FEAR PRICES WILL RISE FURTHER

The central government now faces two dangers. One is the anger of ordinary Chinese. In a recent survey by the People's Bank of China, two-thirds of respondents said real estate prices were too high. A serial drama with the ironic name *The Romance of Housing*, featuring the travails of families unable to afford apartments, was one of the most popular shows on Beijing Television until broadcasting authorities pulled it off the airwaves in November. The official reason was that the show was too racy (one woman got an apartment by becoming the mistress of a corrupt local official), but online chat rooms speculated that the show was cut

DOUG KANTER/THE NEW YORK TIMES/REDUX

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because it was upsetting to people unable to afford apartments.

The debate has become even more charged following injuries and deaths related to real estate. A woman from Chengdu committed suicide by torching herself when her former husband's three-story factory and attached living space were demolished to make way for a new road. A man in Beijing suffered severe burns in a similar protest over his home. In early December five professors at Peking University wrote to the National People's Congress calling for changes to a land seizure and demolition law and accusing developers of usurping the government's role when taking land for construction. The law is leading to "mass incidents" and "extreme events," the professors warned.

The second danger is that Beijing will try, and fail, to let the air out of the bubble. Pulling off a soft landing means slowly calming the markets, stabilizing prices, and building more affordable housing. To discourage speculation, the State Council, China's cabinet, is extending, from two years to five, the period during which a tax is levied on the resale of apartments. Tighter rules on mortgages may follow. Beijing also plans to build apartments for 15 million poor families.

KEY TO GROWTH

The government is reluctant to crack down too hard because construction, steel, cement, furniture, and other sectors are directly tied to growth in real estate; in November, for example, retail sales of furniture and construction materials jumped more than 40%. At the December Central Economic Work Conference, an annual policy-setting confab, officials said real estate would continue to be a key driver of growth.

The worst scenario is that the central authorities let the party go on too long, then suddenly ramp up interest rates to stop the inflationary spiral. Without cheap credit, developers won't be able to refinance their loans, consumers will no longer take out mortgages, local banks' property portfolios will sour, and industrial companies that relied on real estate for a chunk of profits will suffer. It's not encouraging that the Chinese have been ham-handed about stopping previous real estate frenzies. In the 1990s the government brutally ended a bubble in Shanghai and Beijing by cutting off credit to developers and hiking rates sharply. The measures worked, but property prices plunged and economic growth slowed.

Analysts are divided over the probabilities of such a crash, but even real estate executives are getting nervous. Wang Shi, chairman of top developer Vanke, has warned repeatedly in recent weeks about the risk of a bubble. In his most recent comments he expressed fear that the bubble might spread far beyond Beijing, Shanghai, and Shenzhen.

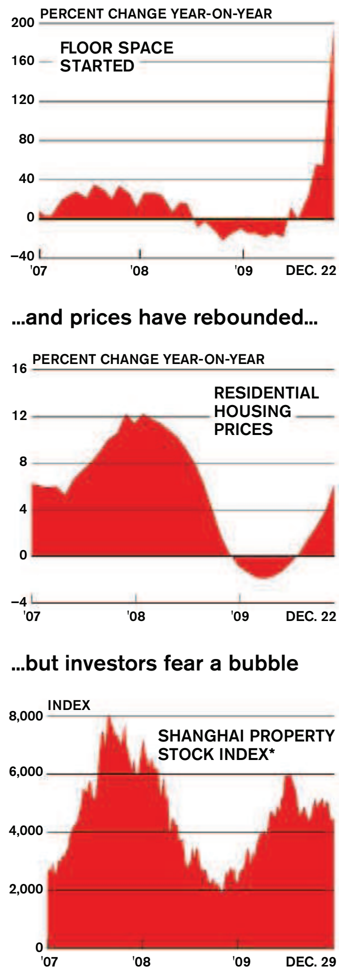
PROFIT VS. SOUL

One difficulty in handicapping the likelihood of a nasty pullback is the opacity of the data. As long as property prices stay high, the balance sheets of the developers look strong. And no one knows for sure how much of the more than $1.3 trillion in last year's bank loans funded real estate ventures. Analysts figure a substantial portion of that sum went into property, much of it indirectly. Banks often lend to state-owned companies for industrial purposes. But the state companies can then divert the funds to their own real estate businesses—or relend the money to an outside developer. Meanwhile, the big banks may be cutting back on their real estate risk by selling loans to smaller local banks and credit co-ops.

For now, the party continues. On Dec. 12, Beijing developer Soho China celebrated a record-breaking year with a gala at the China Central Place JW Marriott. Guests dined on crab and avocado timbale, white bean soup, and beef tenderloin with wild mushrooms (Soho would not comment for this story). After a dance performance, a panel debated "The Balance Between Profit and Soul." When a writer joked he could not afford an apartment—and was still waiting for Soho Chairman Pan Shiyi to give him one—the crowd of 600 well-heeled developers, entrepreneurs, and consultants laughed appreciatively. If the bubble bursts, few will be laughing. |BW|

LAND RUSH

Construction is booming ...



*33 real estate and construction companies
Data: UBS, Bloomberg

Business Exchange

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A Recipe For Trouble

Lax lending by Chinese banks has played a major role in the runup of property prices on some parts of the mainland. A December report by Fitch Ratings says tighter rules imposed by China's bank regulator contributed to a slowdown in new loans in the second half of 2009. The rating agency also noted an increase in off-balance sheet transactions, such as repackaging of loans into wealth management products and the sale of loans to other financial institutions—activities that represent "a growing pool of hidden credit risk."



To read a Bloomberg story on the Fitch report, go to **http://bx.businessweek.com/china-business/reference/**

CHARTS BY DAVID FOSTER

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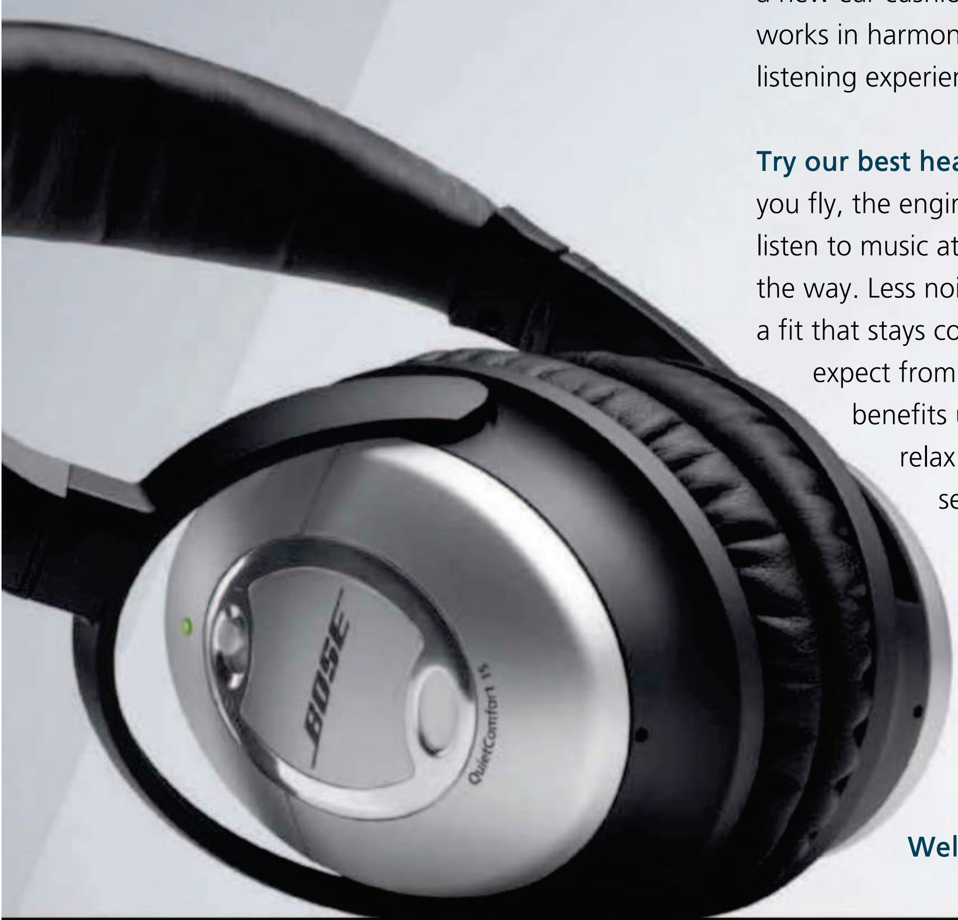
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G.I. BILL OF GOODS

For-profit colleges are raking in millions by signing up soldiers as students. But how valuable is the education they're delivering?

By Daniel Golden

Photograph by Steve Jones

U.S. Marine Corporal James Long knows he's enrolled at Ashford University. He just can't remember what course he's taking. The 22-year-old from Dalton, Ga., suffered a traumatic brain injury, impairing his ability to concentrate, when artillery shells hit his Humvee in Iraq in 2006. He signed up for Ashford, one of at least a dozen for-profit colleges making money off active-duty military with subsidies from American taxpayers, after its recruiter gave a sales pitch this year at a barracks housing the Wounded Warrior Battalion at Camp Lejeune in North Carolina.

Long isn't alone. Ashford ranked sixth in Marine

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Peake earned his bachelor's online while serving with the U.S. Army in Afghanistan

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THE DEFENSE DEPT. BEGAN WORKING ON NEW STANDARDS FOR ONLINE SCHOOLS IN 2004. THEY'RE STILL A YEAR AWAY

Corps enrollment in the year ended Sept. 30, 2009, with 1,018 students. At Camp Lejeune, Ashford had 119 active-duty students, up from 25 the previous year, and 6 in fiscal 2007.

Since 1947 the Defense Dept. has subsidized college tuition for active-duty service members, a benefit intended to boost recruitment and retention. State universities, community colleges, and private nonprofit colleges have traditionally dominated the market. They provide classes on bases under agreements with the military services, and their programs undergo federal review.

Now for-profit colleges specializing in online degrees are making substantial inroads. Their online programs don't require federal contracts and aren't subject to the same scrutiny. Some of them feature easy courses and fast degrees, or entice service members to enroll with free textbooks or laptops. The for-profit schools account for 29% of college enrollments and 40% of the half-billion-dollar annual tab in federal tuition assistance for active-duty students, according to Defense Dept. and military data. The shift is leading to educational shortcuts and overzealous marketing, says Greg von Lehmen, chief academic officer of the University of Maryland University College, the adult-education branch of the state school and one of the oldest and biggest providers of education for military personnel. UMUC competes with the for-profits for active-duty students.

"In these schools, the rule is faster and easier," von Lehmen says. "They're characterized by increasingly compressed course lengths and low academic expectations. One has to ask: Is the Department of Defense getting what it is seeking?" At Apollo Group's University of Phoenix, the biggest for-profit college in the U.S., some active-duty military personnel can earn an associate's degree, which typically takes two years of study, in five weeks.

Of the dozen colleges with the biggest active-duty enrollment, five are for-profits that conduct most or all of their courses online. Three—American Military University, Phoenix, and closely held Grantham—charge $250 a credit, or $750 a course, which allows them to receive the maximum reimbursed by U.S.

BRYAN REGAN

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Drake says an attractive Ashford recruiter got the attention of wounded Marines

taxpayers without service members having to pay any out-of-pocket tuition. Publicly funded community colleges offer classes on military bases for as little as $50 a credit.

Taxpayers picked up $474 million for college tuition for 400,000 active-duty personnel in the year ended Sept. 30, 2008, more than triple the spending a decade earlier, Defense Dept. statistics show. While degrees from any accredited college provide a boost toward military promotion, credentials from online, for-profit schools can be less helpful in getting civilian jobs, especially in a tight labor market. "I'm afraid that the ease with which these outfits hand out diplomas is matched only by the disappointment of their graduates when they find out how little their degrees are actually worth," says Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers in Washington, which includes members from both nonproft and for-profit colleges.

Mike Shields, a retired Marine Corps colonel and human resources director for U.S. field operations for Schindler Elevator, the North American arm of Switzerland's Schindler Group, says he rejects about 50 military candidates each year for the company's management development program because their graduate degrees come from online for-profits. "We don't even consider them," Shields says. "For the caliber of individuals and credentials we're looking for, we need what we feel is a more broadened and in-depth educational experience." He does hire service members with online degrees for jobs on nonleadership tracks, he says.

Most online for-profits, such as American Public Education's American Military University, "do a very good job taking care of students," says Robert Songer, director of lifelong learning at Camp Lejeune. American Military and its counterpart American Public University recently won a national award for quality in online education. But Songer says several schools have become a concern on military bases because of practices that exploit soldiers and the federal subsidies they are promised. "Some of these schools prey on Marines," he says. "Day and night, they call you, they e-mail you. These servicemen get caught in that. Nobody in their families ever went to college. They don't know about college."

Executives at for-profit colleges say they pay more attention to customer service than traditional schools do, and their online format suits military students who move frequently. "It's about flexibility and options," says Rick Cooper, vice-president for military and corporate programs at Columbia Southern University in Orange Beach, Ala. "You can enroll any day of the week, any week of the year." That's not the only allure. Columbia Southern allows soldiers to transfer credits from other institutions for classes in which they earned grades as low as D. Grantham University in Kansas City, Mo., has handed out free laptops, and American Military in Charles Town, W.Va., gives free textbooks as recruitment inducements.

Online schools such as American Military have relocated their headquarters to obtain certification from regional boards with less demanding standards, according to interviews with for-profit-college officials and accrediting agencies. Or they're approved by less established organizations, leaving students hard-pressed to transfer credits to other colleges.

UNEQUAL OPPORTUNITY

Even when graduates find employment, it's likely to pay less. Holders of master's degrees in business administration from for-profits Phoenix and American InterContinental University earn less than grads with the same degrees from the University of Oklahoma or Maryland's University College, according to PayScale, a provider of employee compensation data. Recent MBA graduates from University College and Oklahoma have median annual incomes of $78,600 and $68,400, respectively, compared with $60,200 from Phoenix and $54,600 from American InterContinental, the data show. Apollo spokesman Manny Rivera says students who worked full-time while earning master's degrees at Phoenix in 2008 received an average annual salary increase of 9.7%. "That is a solid indicator of the value of a University of Phoenix education," he says.

Travis Daun, a 33-year-old former Navy lieutenant commander who trained as a nuclear engineer on a submarine, left the service in August after receiving an online MBA from American InterContinental, a unit of Career Education, based in Hoffman Estates, Ill. One of the top 10 reasons for military personnel to enroll at American InterContinental is to "Earn

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your degree FAST," according to a pitch on its Web site. An MBA there can be finished in 10 months instead of the usual two years. "I was disappointed in the rigor and challenge of the courses," Daun says, adding that each course lasted five weeks, with at most two hours a week of class time. "I don't think I had a 4.0 effort, yet I had a 4.0 grade-point average."

Daun is unemployed. His college roommate, who also became a nuclear engineer in the Navy and earned an MBA from the University of Maryland's University College, did find a job, Daun says. "His MBA definitely helped him a lot more than my AIU degree is helping me," he says. Daun turned to Lucas Group, an executive search firm that specializes in placing former military personnel. "Does his master's from American InterContinental open a lot of doors for him? No, it doesn't," says Lee Cohen, a managing partner at Lucas based in Irvine, Calif.

Career Education spokesman Jeff Leshay defends American InterContinental, saying it provides a quality education for adult students. He says the company doesn't track where graduates find jobs.

Some online graduates do find rewarding jobs. While deployed in Iraq, Christopher Brotherton earned a bachelor's degree in homeland security from American Military in 2007. When the staff sergeant retired from the Army in June, his degree helped him land a job teaching social studies in a middle school in Ardmore, Okla. "The state, when they saw my transcript from AMU, they had no problems with any of it," says Brotherton, 42. "It was a respected school to them."

"SOME OF THESE SCHOOLS PREY ON MARINES. DAY AND NIGHT, THEY CALL YOU, THEY E-MAIL YOU"

Still, when service members earn degrees from online for-profits, human resources executives at big companies are often reluctant to hire them, says Cohen. "There are some firms that are heavily credential-oriented," he says. "McKinsey & Co. is one of them. They might balk. Amazon might balk. Shell Oil is another one." McKinsey, Amazon.com, and Shell declined to comment.

The Defense Dept. plans to subject online programs to review by the American Council on Education, a higher-education policy and research group based in Washington, which already monitors face-to-face classes on military bases, Defense officials say. The new online standards, which the department began to develop in 2004, are still a year away from being implemented, says Tommy T. Thomas, Deputy Under Secretary for military community and family policy. "This is a new approach for DOD. We are moving forward with caution to ensure the implementation process goes smoothly," Thomas says.

The expansion of online for-profit colleges into the military comes as the companies face Obama Administration scrutiny over everything from the way they attract prospective students to their increasing reliance on federal financial aid, says Robert Shireman, Deputy Under Secretary of Education. In addition, the Securities & Exchange Commission's Enforcement Division has begun an informal probe into how Apollo Group books revenue. Apollo intends to cooperate fully, the company says.

By expanding its military business, Phoenix has been able to enroll more civilian students who are supported by grants and loans from the Education Dept. without violating federal law that dictates how much revenue the school can receive from the government. Phoenix derived 86% of its $3.77 billion in revenue in fiscal 2009 from the Education Dept., according to its annual 10-K filing, up from 48% in 2001 and approaching the limit of 90% set by a 1992 law known as the 90/10 rule. Tuition payments to for-profit schools by the military don't count toward the 90% ceiling. One way that Phoenix plans to stay below the legal threshold is by building its military business, Gregory W. Cappelli, co-chief executive of Apollo, which is based in Phoenix, said in a June 29 conference call with investors.

When the law was enacted, for-profits hadn't yet moved into the military market, so the legislation's

BRYAN REGAN



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sponsors weren't focused on Defense Dept. tuition assistance, says Sarah A. Flanagan, who helped draft the law as the Senate's specialist in federal student aid. The law was intended to ensure that for-profit colleges offered an education good enough that some students were willing to pay for it, says Flanagan, now vice-president of the National Association of Independent Colleges and Universities, a Washington-based lobbying group. "Counting Defense Dept. funding for servicemen's education as part of the money that's supposed to come out of consumers' pockets violates the purpose of the original legislation," Flanagan says. Apollo spokeswoman Sara Jones says Phoenix began serving military students long before the advent of "the misguided 90/10 rule."

ENROLLMENT SURGE

Phoenix ranks among the top five colleges in enrollment of service members, including about 5,000 in the Army and 2,700 in the Navy, according to the two services. While Phoenix offers campus-based graduate programs in education and management at Air Force bases in the Pacific, most of its active-duty students take classes online, school officials say. Phoenix has 452 recruiters in its military division, up from 91 in 2003, says Scott McLaurin, its executive enrollment counselor at Camp Lejeune, the largest Marine Corps base on the East Coast.

Military enrollment at exclusively online for-profits is soaring. American Military has 36,772 active-duty students, up from 632 in 2000, it says. It has the most Air Force and Marine Corps students of any college. Closely held Columbia Southern says it has 9,582 service members, up from 649 in 2002. Closely held TUI in Cypress, Calif., has more than doubled active-duty enrollment to 7,665 in the first quarter of 2009, from 3,661 in 2004, it says. Six public and private nonprofit colleges hold face-to-face classes on Camp Lejeune, but none has the highest active-duty enrollment there. That distinction belongs to online-only American Military, with 1,623 students, up from 11 in 1999. Phoenix's online enrollment there has risen to 296 from 15 over the same period.

J.B. Beavers, a retired Marine colonel who headed educational services at Camp Lejeune from 2001 to 2006, rejected requests from online for-profits for office space in the base's education center. "I had a jaundiced eye on all of the online for-profits," he says. Beavers' successor, Songer, changed course and gave offices to American Military and Phoenix, which together receive 47% of all the tuition assistance for Camp Lejeune students. "If I have a problem, I can call the school at a very high level," says Songer. "If they weren't on the base, I wouldn't have that leverage."

The active-duty enrollment surge at for-profit schools has led to a slump at public and nonprofit schools. The University of Oklahoma, once the leading provider of graduate degrees to service members, has lost half its military enrollment in a decade, says James Pappas, the university's vice-president for outreach. "A decade from now, you may not find traditional national public and private universities in military education," Pappas says. "That's one of the real dangers."



Songer, director of lifelong learning at Camp Lejeune, says most online for-profits do a very good job

While many colleges adopt what are known as "military-friendly" practices, the online for-profits go further than most. They accelerate courses and degrees for service members, trimming requirements and granting abundant transfer credits. At Phoenix, members of the armed forces can earn an associate's degree by taking as little as one five-week online class, "Written Communication." They can make up for the other 19 courses required for the degree with credits for classes taken elsewhere, military experience including basic training, and passing grades on tests that gauge knowledge of a subject area.

Civilians seeking the same degree must take at least six Phoenix courses and can use credits from outside sources for no more than 14. Traditionally, two-year students must take 10 courses, or half the required load, from the school that awards their degrees, so it can vouch for their training, says the registrar association's Nassirian. Only a handful of active-duty students choose Phoenix's one-course option, called the Associate of Arts Degree Through Credit Recognition, says Mike Bibbee, the university's head of military programs.

At Columbia Southern, students can finish a course in three weeks and gain credit for as many as three classes taken at other colleges in which they received grades as low as D. All exams are open-book. "It would be quite unorthodox for traditional institutions to grant transfer credit to coursework completed below a grade of C," Nassirian says. There are public universities—the University of Alabama, in Tuscaloosa, for example—that do accept Ds for transfer credits. Columbia Southern's Cooper says academic quality is comparable to a state or nonprofit university.

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At American Military, most students take eight-week classes. On Oct. 16 several Marines waited their turn on benches outside American Military's office in the education center at Camp Lejeune. Inside, AMU education coordinator Brian Miller made his pitch to Jyher Lazarre, 19, of Orlando, and Hyunwoo Kim, 20, of Leonia, N.J. Of 20 courses needed for a two-year degree, they could satisfy eight through basic training and other military experience, Miller said. They could test out of seven more, leaving them to take five classes. "I can cut the time of this degree literally in half," Miller told them. "It's going to make you competitive toward promotion as well."

Two policy changes opened the military-education market. In 1999 the Defense Dept. broadened eligibility for reimbursement to include more for-profit colleges. Then it increased funding in 2002 from 75% to 100% of tuition up to the $250-per-credit ceiling.

These moves coincided with the rise of Internet courses. For-profits were ahead of most traditional colleges in online education, which helps service members deployed worldwide keep up their studies. While public schools such as Maryland now offer online courses, they often have stricter requirements. In fiscal 2008, the first year that the Defense Dept. collected such data, 64% of active-duty students took distance-education classes. Soldiers even take online classes in war zones. In Afghanistan, Army Sergeant Patrick Peake earned a bachelor's degree in criminal justice from American Military, enrolling in as many as four online courses at a time. Cavalry scouts "set up a wireless connection at the mud-brick building we were at," Peake, 29, says. After studying counter-terrorism, Peake says, he told friends in Army intelligence about terrorist groups in the region. "This dumb grunt helped them out a little," he says.

ONE SCHOOL CHARGED $4,500, THE MAXIMUM YEARLY MILITARY REIMBURSEMENT, FOR LESSONS ON BALANCING A CHECKBOOK OR USING A PC

Unlike most traditional schools, for-profits vie for students by offering freebies. American Military undergraduates may sell the free textbooks they're given to the school's vendor after use for $30 to $50 per book, Miller says. Columbia Southern's Cooper says the school is considering a similar buyback program.

Grantham, the seventh-biggest recipient of undergraduate tuition money from the Army in fiscal 2008, gave new Dell laptops from March to July to active-duty students who had completed at least four courses with grades of C or better. The free computers were part of a pilot research project on student retention, says Tim Arrington, Grantham director of military programs. Michael Lambert, executive director of the Distance Education & Training Council, which accredits Grantham, advised the school to stop the laptop largesse. "The concern is, schools will outdo each other and we'll have an arms race. Free laptops, free Kindles, free iPods, all coming out of taxpayers' pockets," says Lambert.

Career Blazers Learning Center, a New York-based vocational school, gave away laptops loaded with instructional software to Marines about to be deployed to combat zones, owner Paul Viboch says. It also hired former Marines as recruiters and paid referral fees to students for signing up other service members. Entire units enrolled, and Career Blazers received $4.5 million in tuition assistance from the Marine Corps in 2006, the most of any post-secondary provider.

UNAUTHORIZED PITCHES

Career Blazers charged $4,500—the maximum that the military reimburses in a year—for self-paced lessons on how to perform basic computer applications or balance checkbooks. Because much of the material was available for less expense at workshops or community college classes on bases, "the military overpaid for laptops," says Johanna Rose, an education technician at Camp Lejeune. Relocated to Martinsburg, W.Va., and renamed Martinsburg Institute, Career Blazers stopped giving away laptops three months ago. Its tuition assistance from the Marine Corps slipped to $616,000 in fiscal 2009 as education officials on some Marine bases discouraged service members from enrolling. "I was too successful, too quickly," Viboch says.

Unauthorized marketing pitches by for-profit recruiters have become widespread on military bases. "Some of these schools are a little underhanded," says Pat Jeffress, branch manager of lifelong learning at Camp Pendleton, a Marine base in California. "They try to backdoor me."

One recruiter for Ashford University, a unit of Bridgepoint Education, recently ignored the anti-solicitation rule at Camp Lejeune, says Songer. He says he told the recruiter, whose husband is in the military, that she could only meet students at the base's education center. Instead, she pitched the online for-profit in the recreation room of a barracks for wounded Marines. About 30 Marines showed up, says Brad Drake, a corporal who attends Ashford. "It helped she was really attractive," says Drake, 23, who suffered a traumatic brain injury in Afghanistan when a rocket hit his truck. "That got everyone's attention."

The recruiter spoke at the barracks with the approval of the unit's commander, says Bridgepoint spokeswoman Shari Rodriguez. "We keep our students' needs at the forefront of all we do." Songer says unit commanders are often unfamiliar with educational rules, and that he told the recruiter: "'If you cross that line again, you'll never be allowed on this base."

About 8 to 10 wounded Marines signed up with Ashford after the recruiter's presentation, among them Corporal Long. Besides his brain injury, he has nerve damage and walks with a cane. Long is pursuing a bachelor's degree in organizational management at Ashford. In his first class, students could retake the final test until they passed, he says. "I took it 10 times," he says. "I kept getting the same answers wrong."

Long is married and says he needs to provide for his family. Still, he wonders if he can graduate. "I got my doubts," he says. "My family's more important than my doubts. That keeps me going." |BW|

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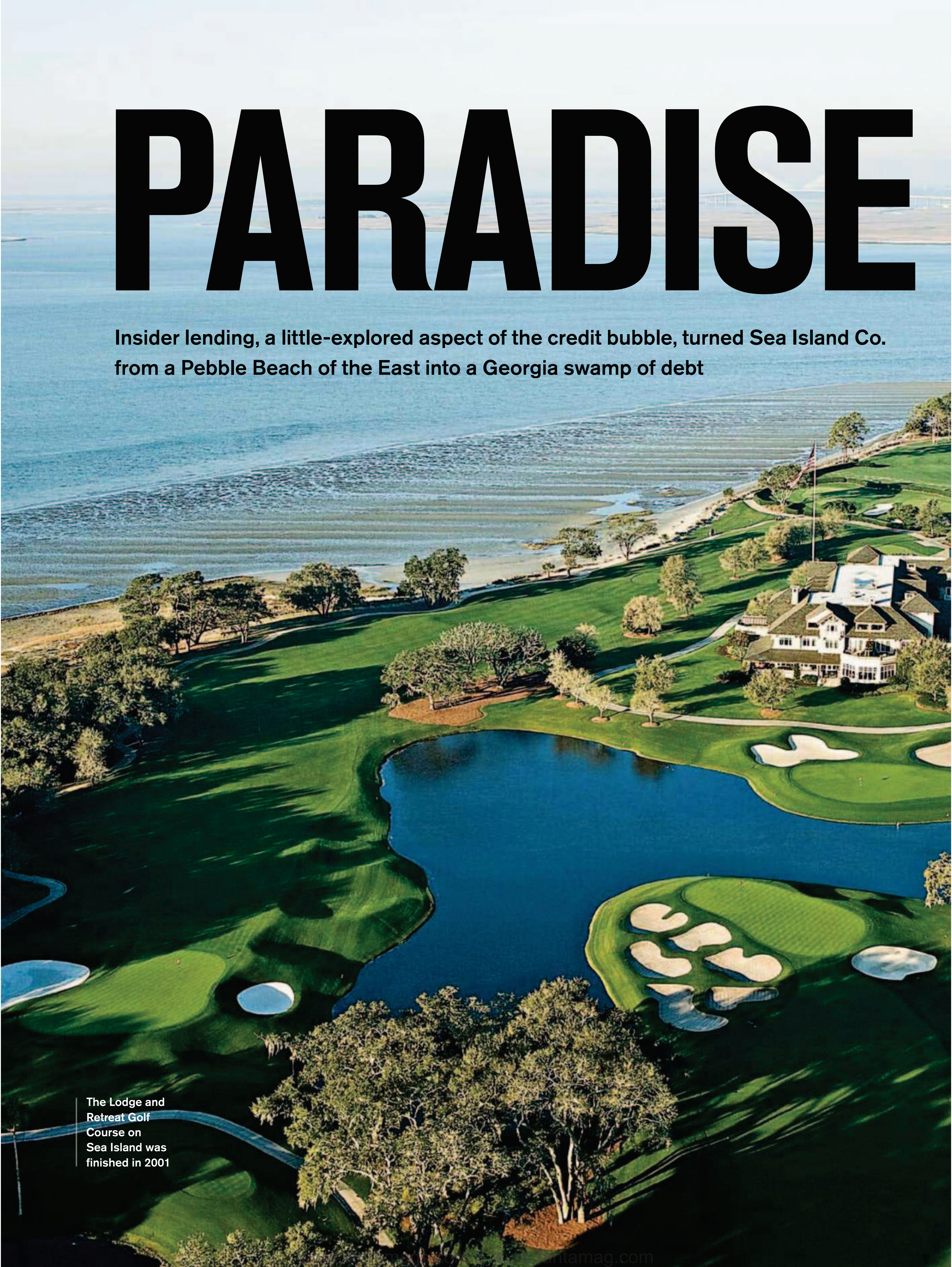
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PARADISE

Insider lending, a little-explored aspect of the credit bubble, turned Sea Island Co. from a Pebble Beach of the East into a Georgia swamp of debt



The Lodge and Retreat Golf Course on Sea Island was finished in 2001



LOST



Jones (left) and Blanchard grew closer as each served on the other's board

By Peter Waldman

A.W. "Bill" Jones III had an eye for the finer things. After taking over his family's sprawling golf resort on Sea Island, Ga., in 1992, he toured America's top clubs for a sense of what the competition had to offer. Soon Sea Island Co.'s clubhouse locker rooms boasted antique wood beams, overstuffed couches, fireplaces, libraries, and mounted game from Jones' hunting trips to Africa.

Had his ambition ended there, Sea Island Co. might still be profitable. But Jones was just getting started. In 2001 he launched a plan to turn his sleepy island retreat into the Pebble Beach of the East, a playground for the global elite. He would rebuild Sea Island's Cloister Hotel and beach club in five-star splendor, replete with fine dining, a luxury spa, squash courts, koi ponds, and, overlooking all the action, high-end condos. The project's price tag quickly swelled to $500 million, but getting the money wouldn't be a problem. Jones sat on the board of a thriving regional bank, Columbus (Ga.)-based Synovus Financial Corp., and his old hunting buddy and family friend, James H. Blanchard, wasn't just the CEO of Synovus—Blanchard also sat on Sea Island Co.'s board.

Even by the relaxed lending standards of the credit boom, the loans for Sea Island Co. were granted with so little fuss that Jones was able to chop several years off of his development plan. As construction began in 2003, he told *Cigar Aficionado* magazine: "The banks almost pay you to borrow money today."

Now Sea Island Co., the company that holds all of Jones' properties, is drowning in debt. With a $35 million payment due by the end of January, Jones is trying to rid himself of several properties and sell equity in the Cloister resort. Sea Island Co. has fired more than 400 workers, or 20% of its staff, in the past two years.

The decline of Sea Island is a spectacular example of the perils of insider lending, which the U.S. Federal Reserve defines as making loans to bank officers, directors, or major

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shareholders. While overall commercial lending soared during the credit bubble, insider lending more than kept pace: According to SNL Financial, insider loans as a percentage of all commercial lending rose from 3.1% in 2001 to 3.3% in 2006. At Synovus, Sea Island Co. was the bank's biggest customer.

Academic research has long correlated insider lending with bank failures. Edward Lawrence, a finance professor at the University of Missouri at St. Louis, co-authored a 1989 study that found that banks with high concentrations of insider loans were four times as likely to fail. "When directors are borrowers, nobody's standing back and saying 'It doesn't make sense to do this loan,'" says Lawrence.

With $1.1 billion in insider loans on its books as of Sept. 30, Synovus, the nation's 34th largest bank by assets, seemed to have a hearty appetite for such deals. It has also had a hunger for federal bailout funds: The bank borrowed $968 million from the U.S. Troubled Asset Relief Program in December 2008. Synovus' stock price plunged 75% in 2009 (through Dec. 29), to just over $2, and the bank axed 800 employees. Spokesman Gregory Hudgison says Synovus' financial condition is sound. Its high level of insider loans, he says, reflects Synovus' "unique" structure, with more than 500 directors of its community banks spread across five Southern states. Jones and Blanchard declined to comment.



Bush joined other world leaders at the G8 economic summit on Sea Island in 2004

PHOTOGRAPH BY CHARLES DHARAPAK/AP PHOTO

At its worst, insider lending is a form of crony capitalism: Businessmen gain easy access to loans, while bankers boost their loan portfolios and, in some cases, take seats on the boards of the companies to which they're lending. The Federal Deposit Insurance Corp., the principal overseer of community banks, is paying closer attention. While it has spent much of the past two years doing triage, seizing and liquidating dozens of shaky institutions, "when the dust settles, one area that I'm sure we'll look at is [bank] governance, including managements and boards of directors," says Fred Gibson, the FDIC's Deputy Inspector General. Adds Sheila Bair, the FDIC's chairman: "I'm deeply skeptical of any kind of insider lending."

SOUTHERN HOSPITALITY

In 1937, Bill Jones III's grandfather, A.W. "Bill" Jones, inherited Sea Island, much of nearby St. Simons Island, and large tracts elsewhere in coastal Georgia from his cousin, Howard Coffin, who had been a top engineer for Oldsmobile and Hudson Motor Car.

Jones' resort grew slowly, subsisting mostly on cash flow from the Cloister Hotel and proceeds from occasional land sales. (Jones Sr. swore off debt, says Blaine Kelley Jr., an Atlanta developer who knew him.) Families from across the South would flock to Sea Island every summer, holing up in rental homes brokered by Sea Island Co. or in rooms at the Cloister, where the Joneses would roll in cots to accommodate the overflow. Through the mid-1980s, the Cloister's rooms didn't have TVs and the front desk didn't take credit cards. Parents dropped their kids off at the beach club, where they were watched over by some of the same people who had watched over the parents years earlier. Bill Jones Jr., an avid hunter and farmer, ran the company from 1966 to 1992; former employees say he fixed toilets himself.

Bill Jones III grew up helping his dad manage Sea Island. After graduating from Valdosta State College in 1981, he worked at various Florida beach resorts, where he saw firsthand how high-end places were operated. When Jones took over at Sea Island, he decided to go upscale, says Peter Capone, an architect who has implemented many of Jones' ideas over the years. Jones hoped Sea Island's beach and golf resort would attract the world's wealthy, who ultimately would buy vacation homes there. "The whole model was, 'This is a land company,'" Capone says.

The strategy worked, at first. Luxury beach properties in Sea Island's first gated community, Ocean Forest Golf Club,

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sold briskly in the 1990s. In 2001, Jones completed the $52 million Lodge and Retreat Golf Course on St. Simons Island, which earned raves in the travel press.

Meanwhile, Jones was becoming closer with Blanchard, a longtime family friend and Sea Island resident whose 4,200-square-foot home is now on the market for $7.2 million. The two shared passions for golf and hunting and an interest in servant leadership, a management philosophy based on the idea that corporate executives should emulate Jesus Christ as stewards of their workers and communities. In 2000, Blanchard, then 59, offered Jones a seat on Synovus' board, and Jones, then 42, reciprocated, offering Blanchard a seat on Sea Island Co.'s board.

Fresh off the success of the St. Simons Island project, Jones set out to remake the Cloister and develop Sea Island Co.'s most ambitious project to date: the 3,000-acre Frederica community at the north end of St. Simons Island, a wooded enclave with a 400-acre man-made lake, a PGA championship golf course, deepwater river frontage, and sites for 400 homes he hoped to sell for more than $1.5 million per lot.

Soon Jones and Blanchard drew up plans for what they initially expected would be about $350 million in loans. The deals apparently were approved with minimal board oversight. "I didn't know about the size of the loans when they were made," says C. Edward Floyd, a Florence (S.C.) surgeon who served on Synovus' board from 1995 until 2006 and was on its governance committee at the time the loans were made. Floyd, the only one of 18 current and former board members who agreed to talk to *Bloomberg BusinessWeek*, says that when the board did discuss the Sea Island loans, Jones would leave the room. The interlocking directorships of Blanchard and Jones were never mentioned, he says. "I know Jimmy Blanchard well," says Floyd, "and I can't imagine he would do anything unethical."

Richard E. Anthony, Synovus' current chairman and CEO, criticized the Sea Island loans during an April 2009 conference call with analysts, saying they were "a much higher exposure than we think is appropriate." But in a written statement to *Bloomberg BusinessWeek*, James D. Yancey, a Synovus director and former chairman who was the bank's president at the time of the Frederica loans' issuance, defended them. "The decision was based upon the economic environment at the time, an independent review of Sea Island's risk profile, our own risk management standards, and compliance with federal regulations," he wrote in an e-mail message to *Bloomberg BusinessWeek*. "Our lending relationship with the Sea Island Co. predated Jones' involvement as a member of the Synovus board." Hudgison, the Synovus spokesman, adds that the loans received an extra level of scrutiny because of Jones' status as a bank insider.

THE BEST OF EVERYTHING

When the Frederica project kicked off in 2003, Jones' confidence was running high. "Our vision is to be the finest resort company in the world," he told *Cigar Aficionado* in 2003. "We want to be No. 1 in everything." To sell multimillion-dollar home lots, Sea Island needed to lure a much wealthier clientele than the Southern families who'd vacationed there for decades. So Sea Island's $65 million spa included a soaring wood atrium, rivulets and koi ponds, 26 treatment rooms, carved mesquite furniture, organic food, and nutritional counseling. There were three squash courts and, when the spa opened in 2006, a resident squash pro who was among the top-ranked doubles players in the world.

Sea Island hosted the annual G8 Summit of world leaders in 2004, and properties were moving. Luxury condos above the Cloister's new beach club quickly sold out, nearly covering the cost of that 160,000-square-foot facility, Capone says. Lots at exclusive Frederica presold for $1.5 million and up in 2005 and 2006, according to Frederica property owners and former Sea Island executives. Buyers included former Senator Sam Nunn (D-Ga.), Siebel Systems founder Tom Siebel, and professional golfers Davis Love III and Zach Johnson. (Nunn did not return phone messages at his St. Simons Island home; the others declined to comment.) Jones was named "2004 Georgian of the Year" by *Georgia Trend* magazine.

In March 2006, Jones threw a black-tie gala to celebrate the reopening of the Cloister. As guests sipped cocktails in the main hall, the sunset glinted off the Black Banks River behind the hotel, filling the three-story colonnade with an orange glow. "It was breathtaking," recalls Pamela Hughes, the interior designer who spent three years filling the new resort with custom-made furniture from China, specially woven carpets

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The Cloister in 1941 (left) and in September, after Sea Island's $500 million makeover

(TOP TO BOTTOM) PHOTOGRAPHS BY ALFRED EISENSTAEDT/TIME LIFE PICTURES/GETTY IMAGES; STEPHEN MORTON/THE NEW YORK TIMES/REDUX

from Turkey, draperies from English 18th century looms, and antique hardwoods from shipwrecks at the bottoms of North American rivers. "It was right out of *The Great Gatsby*," she says.

The good times didn't last. By 2007 the housing slump had hit Sea Island, and its traditional clientele quickly pulled back from paying the resort's higher prices for everything from room rates—which ran upward of $500 a night—to the golf courses' greens fees. To allay property owners' concerns, Blanchard, who had retired as CEO and chairman of Synovus but stayed on its board, reassured them at Sea Island Club's annual meeting that Synovus still had great confidence in Sea Island Co., its largest borrower. This even though Sea Island had already gone through about $100 million from Frederica lot sales and had to borrow more money, and turn some condos into time shares.

As Blanchard spoke, Sea Island's real estate office was keeping two sets of sales reports, according to two former real estate executives with the company. One set, for prospective property buyers and bankers who came in to tour the project, showed lots for sale and lots already sold. The other report, dubbed the quiet inventory, was for internal use only and showed a truer picture of Sea Island's health. Sea Island Co.'s corporate office had induced several people to upgrade their lots, say these former executives, who requested anonymity to protect their severance packages from Sea Island. But only the quiet inventory report showed the value of the property that Sea Island had taken back from the buyers in exchange for the upgraded lots, these people say. The reports shown to many outsiders were far rosier, say the executives. "As a matter of policy, Sea Island Co., as a private firm, does not discuss its business operations," spokeswoman Merry Tipton wrote in an e-mail to *Bloomberg BusinessWeek*. "However, if we are to take from your questions the inference that our company kept two sets of financial information regarding the sale of property, then we must respond by categorically denying such an inference."

Jones brought in cost-cutting managers to trim amenities such as full butler service for all Cloister rooms, in hopes of appealing to a broader swath of vacationers. "As they abandoned one demographic and tried to embrace another, they never gave either one enough time to adjust," says Jim Root, who, after four years of managing some of Sea Island's high-end amenities, left last year to run Glen Ivy Hot Springs Spa near Los Angeles. Jones recently told Sea Island Golf Club members that he's "trying to get back to our roots" and lower prices, one member says.

Now Jones is scrambling to keep Sea Island Co. afloat. To avert foreclosure on about $150 million in loans, he deeded the Frederica development and about 500 acres of land on St. Simons Island to creditors in November. He has also held talks with potential investors in the Cloister resort, including Herb Kohler Jr., the plumbing products magnate, who has visited Sea Island to see how the properties might fit with similar golf resorts that Kohler Co. operates in Wisconsin and Scotland. A spokeswoman for Kohler declined to comment.

The Sea Island debacle might have been prevented had Synovus' underwriters asked more questions before making the loan. But "handshake deals aren't unusual in the world of small-town banking, where the bank's CEO, the car dealer, and the furniture store owner all sit on the board," says Richard Hyatt, a Columbus (Ga.) journalist who has followed Blanchard for 30 years. "The question I would ask is, how appropriate was this in the arena they were playing in with Sea Island? Now I think we've seen the answer." | BW |

–With Laurence Viele Davidson in Atlanta and David Mildenberg in Charlotte, N.C.

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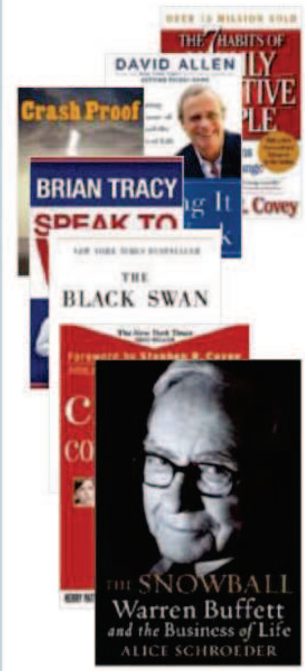
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WHAT'S NEXT



O'Reilly: "We see ourselves as canaries in the coal mine"

ERIC MILLETTE

STRATEGY & COMPETITION

Trying to Avert a Digital Horror Story

Amazon's growing might and the Kindle's success have prompted frightened publishers to fight back

By Spencer E. Ante

On Christmas Day, for the first time in its history, Amazon.com sold more digital books than the old fashioned kind. It was a watershed moment for the book industry—but it's scaring the hell out of traditional publishers. Even though they make the same amount on sales of both kinds of books, they see Amazon's digital dominance as a looming threat to their business, and with good reason. Their big worry: Amazon will end up with the same kind of pricing power in books that

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Apple has in music, and that the book industry will suffer the same kind of bruising decline.

One goal for publishers is to dilute Amazon's power. Hachette is selling e-books through more than a dozen partners, including Sony, Apple, and small retailers such as Fictionwise. By partnering with multiple outlets, publishers hope to regain control over pricing and gather purchasing data that could fuel future sales. They're unhappy Amazon has dropped the price of some new digital best-sellers to as little as $7.99, compared with $35 for hardcovers. Hachette and Simon & Schuster plan to delay the release of certain digital books for several months to avoid undercutting the sale of best-sellers. "We are giving away the family jewels," says David Young, chairman and chief executive of Hachette Book Group, which publishes authors Malcolm Gladwell and Walter Mosley.

O'REILLY IS OFFERING UNLIMITED ACCESS TO ITS TITLES FOR A MONTHLY FEE

Publishers are typically paid about half the hardcover's retail price, whether a digital book or hardcover is sold. But Amazon has been pushing to pay them less, and many publishers think cheap digital books will open the door to lower industry revenues in the future. Amazon, for its part, says publishers' concerns are overblown. "We are selling a lot of books for publishers. We feel like that relationship continues to be a good one," says Ian Freed, Amazon's vice-president for the Kindle business.

Several publishers are trying to reinvent their businesses before Amazon, or someone else, does it for them. "We are thinking very hard about what opportunities there are to prevent our business from being destroyed," says Young.

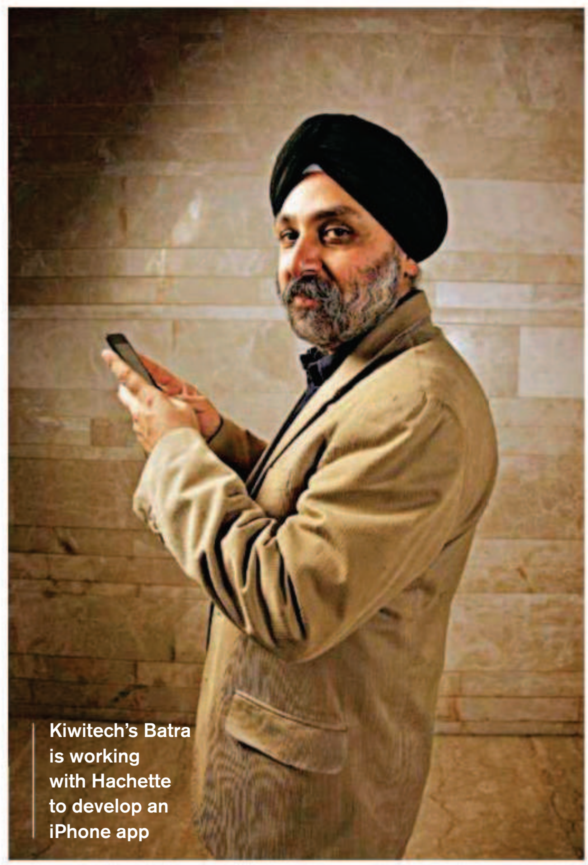
Next year Hachette is coming out with a digital version of Sebastian Junger's *War* that will include video clips, a first for the company. (The book, scheduled for release in May, is based on the author's reporting in Afghanistan and the footage will feature firefights and interviews with soldiers.) HarperCollins is selling a collection of classics on the Nintendo DS handheld gaming device. Meanwhile, O'Reilly Media, which produces software user manuals, is testing completely new pricing schemes. Instead of selling individual books, it's offering unlimited access to 10,000 titles, videos, and pre-publication manuscripts on the Web for $42.99 a month. "Our mission is not making books," says Tim O'Reilly, the company's CEO and founder. "It's changing the world through spreading the knowledge of innovators."

Young believes people are interested in paying for variations on the standard book, say a single chapter or a searchable database. In late September, two authors, a few editors, and a technologist gathered in Hachette's New York City office to work on an iPhone application based on the popular food book, *What to Drink with What You Eat*. The heavily illustrated volume will have to be adapted for a screen smaller than a playing card. Gurvinder Batra, chief technology officer of Kiwitech, a Washington (D.C.) startup Hachette hired to develop the app, handed out printed shots of the screen and navigation. "To get to the right info I should not do more than two or three clicks," said Batra.

The team decided the app should be like a virtual sommelier *cum* food critic, featuring food and wine pairings and tutorials on flavor balancing. Then they moved on to the touchy subject of pricing: Should they charge for the app? Most iPhone apps are free or very cheap. "We are in publishing," said Siobhan Padgett, digital sales and marketing manager at Hachette. "We have to make money." The hardcover of *What to Drink with What You Eat* lists for $35, and the Kindle edition goes for $19.25. Hachette editors eventually decided to charge $4.99 for the app, which is coming out in January. "We think we can sell a whole lot of these at this price," says Padgett.

Hachette doesn't disclose how much revenue it pulls in from its digital efforts, but the company is doing well. Strong sales of Stephenie Meyer's *Twilight* series, Teddy Kennedy's *True Compass*, and Malcolm Gladwell's *Outliers* helped boost revenues 15% over the first nine months of the year.

Harlequin Enterprises, the 60-year-old publisher of romance novels, started offering all its books in electronic form in 2007 and is now experimenting with several new digital formats. One, called Spice Briefs, seeks to publish short-form erotica, running 5,000 to 20,000 words long, as e-books. Another involves publishing short digital prequels, which bring in



Kiwitech's Batra is working with Hachette to develop an iPhone app

MICHAEL RUBENSTEIN/REDUX

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extra revenue and tend to pump up print sales. Gena Showalter, a popular author of young adult novels, wrote a prequel for her *Lords of the Underworld* series that came out one month before the first print book and sold for $2.99. The book, *The Darkest Night*, debuted at No. 8 on *The New York Times* bestseller list and has sold 220,000 copies, vs. 130,000 copies of her previous book.

Harlequin CEO Donna Hayes says electronic books account for about 6% of total sales now, but she expects that to double in a few years. She says digital sales appear to be adding to the company's revenue, rather than cannibalizing traditional sales. Harlequin's revenues rose 7% over the first nine months of the year, while U.S. book sales were up 3.6%. "It has grown our business so far," says Hayes.



Hachette's Young: "We are giving away the family jewels"

BILL WADMAN

THE NETWORKED BOOK

Tim O'Reilly may be pushing experimentation further than anyone. His company's decision to sell monthly subscription access to all its user manuals and other materials has been a hit with companies, universities, and training organizations, growing to 20% of overall revenue. "We see ourselves as the canaries in the coal mine," says O'Reilly.

Today, O'Reilly is trying out several new digital products, including one he calls the "networked book," an attempt to get readers involved in the creation of books through interaction over the Web. The company began by letting readers review authors' original manuscripts several months prior to a book's publication and now is allowing readers to post comments on manuscripts.

In the company's San Francisco office, engineer Keith Fahlgren fired up his laptop to show off a Web site for a book called *The Real World Haskell*, a user guide for a computer programming language. Software that Fahlgren created let 750 people post 7,000 comments for the authors to read. Many reader postings influenced the final version of the book. "This chapter seems a little bit too much like an essay," wrote one reader. "Follow the old rule, show, don't tell." Co-author Bryan O'Sullivan wrote on his blog that the feedback had "a profound effect" on the book. "We have used your input to make our coverage both more correct and more accessible," he said.

O'Reilly and other publishers are cultivating Apple as an alternative to Amazon. One reason: More than 50 million people have the company's iPhone or iPod Touch, which can be used to read digital books, compared with just four million who have electronic book readers. O'Reilly says his company is generating far more sales from Apple customers than Kindle users. O'Reilly currently offers 500 books on the iPhone, compared with 350 Kindle titles. Another 500 iPhone titles are in the works.

O'Reilly is already reaping the benefits of his investments in technology. But Young and other publishers acknowledge they don't know how all this experimentation will pay off. Still, they know they need to figure out the digital future before they lose out to Amazon or another aggressive newcomer. "We've got a long way to go before we can recoup our digital investments. The costs have been huge," says Young. "But I am optimistic, provided we sustain a healthy industry." | BW |

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The Debate over Book Delays

Should book publishers delay releasing the digital versions of popular books? There has been fierce debate over that question ever since the Hachette Book Group and Simon & Schuster said in December they plan to hold back digital versions of certain upcoming titles for several months after the hardcover's release. Nathan Bransford, a literary agent in the San Francisco office of Curtis Brown Ltd., argued against such delays on his blog, since he believes they will simply aggravate would-be readers. "We've seen repeatedly over the last decade, alienate digital consumers at your peril," he warned. "The best deterrent against piracy is making a digital edition readily available for sale at a fair price. Resisting the conversion to digital sure didn't work for the music industry."



To read his blog post, go to **http://bx.businessweek.com/e-books/reference/**

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INNOVATION & TECHNOLOGY

On the Brink of An MS Breakthrough

A number of improved treatments will be available soon. Which drugmakers will gain the upper hand?

By Kerry Capell

When Thomas Bullock was diagnosed with multiple sclerosis in 2001, several new treatments for the incurable, nerve-destroying condition had just hit the market. The automotive worker from Ontario spent two years on Bayer's blockbuster Betaseron, an injectable drug that can suppress a hyperactive immune system. But instead of getting better, Bullock endured constant flu-like symptoms and numbness in his limbs. When he developed severe nerve damage, he ditched the injections. "My body just couldn't handle it," recalls Bullock, now 41.

Then, in 2007, he joined a clinical trial for an experimental pill, Fingolimod, from Novartis. His MS hasn't flared up since. "This is the best shape I've been in for years," he says.

Bullock is one of an estimated 2.5 million MS patients worldwide with fresh cause for hope. Fingolimod and a slew of other drugs that attack MS in new ways are expected to become available starting in 2010. With 10 treatments in late-stage development and more than two dozen in early-stage research, some doctors believe therapy for the illness is at a turning point. Although doctors can't say which drugs will succeed, "we are getting closer to stopping the progression of the disease," says Dr. John Richert, a top executive at the National Multiple Sclerosis Society.

Switzerland's Novartis is vying with Germany's Merck to be first with an oral treatment, pursued closely by France's Sanofi-Aventis, Israel's Teva Pharmaceuticals, and Biogen Idec in Cambridge, Mass. If regulators approve any or all of these products, the painful injections and infusions patients endure today may become obsolete—and the global market for MS drugs, currently at $8.8 billion, could double within five years, according to consultants Frost & Sullivan.

When MS strikes, rogue immune cells travel to the brain and spine, attacking and destroying myelin, the protective insulation surrounding nerves. These mysterious attacks produce sclerotic scar tissue and disrupt messages from the brain that control muscle movements, with symptoms ranging from mild numbness to paralysis and blindness.

MS drugs seek to quell these assaults. But any tampering with the body's immune reactions can be dangerous. "There is balance between treating the disease and potentially increasing the risk of infection and cancer," says Dr. Jeffrey Cohen, director of experimental therapeutics at the Cleveland Clinic's Mellen Multiple Sclerosis Center. Consider Tysabri, one of the most potent weapons against MS, which works by confining wayward immune cells in the bloodstream. The drug, made by Biogen Idec and Elan Pharmaceuticals, has been used by 65,000 patients. Of these, 28 have developed brain infections, and 7 have died.



Bullock is in "the best shape I've been in for years" thanks to Fingolimod

PETER SIBBALD

The new wave of MS drugs face tough scrutiny. Fingolimod, for one, works through an entirely new mechanism: It traps the marauding immune cells in the lymph nodes, keeping them from entering the bloodstream. A two-year study shows it reduced the relapse rate in MS patients by 54%. It also may increase the nervous system's ability to protect itself, as may Biogen Idec's new pill, BG-12, says Richert.

What doctors can't guarantee is that the drugs will suppress the illness without triggering infections. "We desperately need new drugs for MS," says Dr. Mark Keegan, section chair of multiple sclerosis at the Mayo Clinic in Rochester, but "any new medication that alters the immune system needs to be used with caution." |BW|

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Honest, Hollywood, Netflix Is Your Friend

That's Ted Sarandos' message in his bid to bring new films to your PC or TV. But the studios aren't buying

By Ronald Grover, Adam Satariano, and Ari Levy

In the paranoid precincts of Hollywood, a question has been making the rounds: Is Ted Sarandos friend or foe?

Sarandos is the content chief at Netflix and one of the studios' most devoted customers. Each year, on behalf of his company, he buys an estimated \$240 million worth of DVDs that Netflix then mails out to its subscribers. All was going well until Sarandos last year cut a deal with Starz, the movie channel, to stream Walt Disney and Sony films, including *Ratatouille* and *Spider-Man 3*, to subscribers' PCs, Web-connected TVs, and game consoles. For an industry that jealously protects its right to license movies to the highest bidder, the move amounted to an end run.

Why would Sarandos risk angering Hollywood? Because Netflix, having prospered in the DVD rental business, needs to position itself for a future when viewers will be able to watch any movie or TV show they want instantly on their PC, TV, mobile phone, game console, or tablet. Netflix has a powerful brand and slick streaming technology. But to stay relevant the company needs access to much more of the studios' digital content. Otherwise Netflix could be overwhelmed by deep-pocketed rivals—from the cable companies to Amazon.com, Google, and Apple to the studios themselves.

Lately, Sarandos, 45, has been shuttling between Hollywood power lunches, film festivals, and awards dinners, telling anyone who will listen that Netflix is not the enemy but a bridge to the future. "Don't forget, the studios have fought every form of home entertainment," Sarandos wrote in an e-mail to *Bloomberg BusinessWeek*. "And TV and DVDs have become their largest sources of revenue and profits."

Netflix' 11-year-old DVD-by-mail model has already transformed the movie rental business. And Sarandos, who has worked for Netflix since 2000 and last year pulled down a \$1.1 million salary, played a big role in the company's success. It was Sarandos, working from a Beverly Hills office, who persuaded the studios to allow Netflix to buy DVDs for much less than, say, Wal-Mart Stores. The cut-rate deal allowed Netflix to offer subscriptions for as little as \$8.99 a month and grow into the largest mail-order DVD renter of its kind. This year Netflix is on track to earn some \$111 million on sales of \$1.67 billion, a 22% gain over 2008. Its stock is up 90% this year—partly on rumors that Amazon or Apple might buy the company. CEO Reed Hastings says he expects to be mailing out DVDs 20 years from now.

That hasn't prevented Hastings from hedging his bets, however. Three years ago Netflix launched Watch Instantly, an online service on its existing Web site. With a couple of mouse clicks subscribers can watch a limited selection of movies and TV shows right away rather than wait for them to arrive in one of Netflix' trademark red envelopes. The company says 42% of its 11.1 million subscribers have tried the service, twice as many as last year. Still, Netflix does not disclose how often its customers use the streaming service, and analysts believe that it is tiny next to the DVD business.

To turn the service into the real deal,





Netflix bypassed the studios to win digital access to *Spider-Man 3* and *Ratatouille*

(CLOCKWISE FROM UPPER FAR RIGHT) PHOTOGRAPHS BY JOHN M. HELLER/GETTY IMAGES; WALT DISNEY CO./COURTESY EVERETT COLLECTION; SONY PICTURES/COURTESY EVERETT COLLECTION

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Sarandos (left) isn't likely to accept studios' payment plan for streaming video

Netflix will have to build a compelling online library. Right now Watch Instantly features only 17,000 films and TV shows, compared with Netflix' 100,000 or so titles on DVD. And apart from the few Sony and Disney films Netflix got from the Starz deal, the selection is dated. Thomas Lesinski, Paramount Digital Entertainment's home entertainment chief, wrote in an e-mail that he lets Netflix stream older titles "but not new releases."

ONE MOVIE, MANY SALES

That's because the studios don't want to blow up a business model that allows them to sell the same movie over and over in various formats and venues. Typically, films move from cinemas to stores, to cable and satellite pay-per-view, to premium channels like HBO, then to basic cable and broadcast—with the studios cashing in at each step. Plus, having watched the implosion of the music and newspaper industries, the studios are moving cautiously online. "Everybody views it as a terminal career decision if you get it wrong," says Frank Biondi Jr., a former Viacom president and CEO who now works for WaterView Advisors, a New York private equity firm.

Before Sarandos can persuade the studios that Netflix is a safe place to stream their movies, however, he has some serious diplomacy to do—and not just because of the Starz deal. Studio executives partly blame cheap rentals from Netflix and its ilk for cratering their retail DVD business. In August, Warner Brothers said it would stop selling its DVDs to video subscription services like Netflix until 28 days after it sold them to retailers like Best Buy or Wal-Mart unless they paid more for the discs. Hastings has said he might accept the 28-day rule but won't commit until the two sides negotiate the price. If Warner and Netflix cut a deal, other studios likely will follow suit.

Persuading the studios to let Netflix stream more recent films will be a lot harder, however. The studios are willing to do so—but there's a catch. Warner Brothers and other studios want Netflix to accept the same deal Hollywood has with the cable companies. They charge about $4 each time someone watches a new movie and then kick the studios 65% to 70% of the take.

Hastings and Sarandos aren't likely to bite, because Netflix subscribers are used to getting cheap all-you-can-eat subscriptions. Would you pay $4 to stream a film when you can watch as many as you want for $8.99 a month on DVD? The arithmetic doesn't add up.

Sarandos declined to discuss the talks with Warner Brothers. But his position is plain. He is offering to write big checks up front for the right to stream movies as often as people want to watch them. "What everyone else is asking the studios to do is 'give me your content, and if I do a really good job of putting it in front of the right people and I sell ads for the right prices, then I'll give you half,' " Sarandos said in an interview. "What I'm saying is, I'm paying what Showtime will pay you, and there's no reason not to do this deal with me."

Sarandos does have a bargaining chip that the studios like even more than a $100 million opening weekend: plenty of cash. He has been going around Hollywood making the point that Netflix will pay the U.S. Postal Service $600 million this year to ship DVDs to subscribers. "I'd love to be paying that to the studios," says Sarandos. "That's real money. But I have to get the content." |BW|

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A Red Envelope's Journey

Netflix' 58 distribution centers process approximately 2.2 million DVDs per day. *USA Today* reporter Jefferson Graham toured a sorting facility in Fremont, Calif., this summer to watch the intricate ballet between man and machines.

To view the video, go to **http://bx.businessweek.com/netflix-inc/reference/**

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FINANCE

Should This Man Be a Banker?

Billionaire real estate developer Stephen Ross, with the FDIC's blessing, is looking to snap up failed banks



Ross and his partners have agreed not to sell any bank they buy for three years

By Jonathan Keehner and Jason Kelly

Stephen M. Ross, the billionaire real estate developer who founded the Related Companies in New York, wants to be a banker. Somewhat surprisingly, regulators are letting it happen. The Federal Deposit Insurance Corp. has approved a proposal by Ross and fellow Related executives Jeff Blau and Bruce A. Beal Jr. to allow their new financial firm, SJB National Bank, to buy failed banks from the government and make them profitable again.

For much of the past year the FDIC had been reluctant to let private equity investors buy banks directly, even as bank failures surged. That's because private equity makes money by borrowing money, buying companies, restructuring them, and then selling them. Regulators were wary that dealmakers wanted to acquire banks only to try to flip them for quick profits. So while they allowed a few "club" deals involving several private equity firms, they didn't greenlight any big solo purchases.

The SJB executives, who have developed such Manhattan properties as the Time Warner Center, would seem to pose precisely the type of threat that regulators feared. The FDIC signed off in October because the developers have deep experience in the kinds of real estate loans on many banks' books, and agreed not to sell any banks they buy for three years. What's more, Related said it wouldn't take a direct stake in the firm, whose moniker derives from the first initial of each of the founders' names. Instead, Ross, Blau, and Beal are putting up $100 million of their own money and are collecting about $800 million from outside investors. "It won't embarrass regulators if SJB makes money," says Steven Kaplan, a professor at the University of Chicago. The FDIC declined to comment.

HOW TO PLAY IT 59

SOROS AND McCOLL

Ross, 69, is an unlikely banking mogul. The University of Michigan graduate started his real estate business in the unglamorous realm of low-income housing. In 1990, Ross hired Blau, another Michigan alum, as an analyst to do everything from new business development to loan workouts. Blau has never left, even while earning a master's degree by commuting from New York to the University of Pennsylvania's Wharton School of Business in Philadelphia. Beal, 39, joined Related in 1995 to assess deals.

Related's dealmakers like the prospects for lending now. "There's a huge need for financing in real estate, auto, and consumer businesses," says Blau. "For anyone with sufficient access to capital, there is a tremendous opportunity." SJB is looking to buy a bank with $8 billion to $15 billion in assets.

Others are taking notice. Former Bank of America Chief Executive Officer Hugh L. McColl Jr. and Chief Financial Officer Marc D. Oken are backing a group out to buy Florida banking assets. Some private equity players already in banking are getting more aggressive. A consortium that includes J. Christopher Flowers and George Soros bought the remains of the failed IndyMac Bancorp last year. Now they're using the bank, renamed OneWest, as a vehicle to buy other troubled banks, most recently First Federal Bank of California.

Meanwhile, the FDIC's resources are dwindling, and bank failures are at a 17-year high. If the agency can figure out how to tap more private money without raising taxpayers' ire, its job will get a lot easier. Ross and Co. "have never run a bank before, but they're operators who know real estate," says Kaplan. "That must be appealing to regulators." | BW |

CHRIS CASABURI

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JARED McMILLEN

MANAGEMENT & LEADERSHIP

Now for Sale, The Zappos Culture

The online shoe seller is marketing its playful, customer-friendly model to other businesses

By Christopher Palmeri

Visitors touring Zappos.com's suburban Las Vegas headquarters can see Chief Executive Anthony C. "Tony" Hsieh waving from his cubicle or get their photos taken in goofy, mullet-shaped wigs. On the tour, which the online shoe retailer offers 16 times a week, staffers blow horns and ring cowbells to greet the guests, who move among the aisles in groups of 20, trying to get a handle on the company's unique culture. "The original idea was to add a little fun," Hsieh explains. Then it all escalated "as the next aisle said, 'We can do it better.' "

Zappos already knows how to sell shoes. Now it's hoping to profit from people's fascination with its friendly, antics-filled business model. Last summer, the company began holding two-day, $4,000 seminars on how to recreate the essence of its corporate culture. At the third such session, last October, the 25 attendees included an executive from the Girl Scouts, some competing e-tailers, and an entrepreneur from Scotland—a market Zappos doesn't even serve. In coming weeks the company will also relaunch Zappos Insights, a Web site offering management videos and tips from staffers at a cost of $39.95 a month.

The goal behind these activities is to build more buzz around the Zappos brand and its extreme customer service. Hsieh, 36, is an avid consumer of management tomes. He has 1.6 million followers on Twitter—more than either CBS News or the NFL—and he regales these fans with inspirational quotes, riffs on the news, and whatever else is on his mind. In the October seminar, which will be repeated once every quarter, Hsieh, the chief financial officer, and two dozen other staffers shared tips on hiring, compensation, customer care, and creating the right work environment.

One big Zappos fan is Amazon.com founder Jeffrey P. Bezos. On Nov. 2, Amazon completed its purchase of Zappos for shares worth $1.2 billion.

Hsieh allows sales reps to wing it when it comes to coddling customers

There's certainly much for students of management theory to try on at Zappos. For example, pay for call-center operators starts at a modest $11 an hour, and there are no bonuses or 401(k) matching contributions because Hsieh believes the most productive employees work for the psychic gratification in helping others. Customer service reps are given plenty of freedom. They may chat for hours with customers, write thank-you notes, send flowers, and even direct shoppers to rival Web sites if an item is out of stock. In a tough year for retail, sales are up by double digits.

Zappos rep Michelle Robles recently showed a reporter how the approach works. She offers coupons and free shipping to one unhappy customer while grabbing a returned pair of shearling boots for another. Robles knows her top priority is to establish an emotional connection. More than 95% of Zappos' transactions take place over the Web, so each actual phone call is a special opportunity. "They may only call once in their life, but that is our chance to wow them," Hsieh says.

A Zappos seminar last July impressed David Brautigan, who runs a family heating and air-conditioning repair business. It prompted him to fire 12 employees who were "just not being nice," while rewarding those who remain with such perks as sky diving trips. "The nicer we are to people," he says, "better things are happening." Hsieh appears pleased to spread that message: "Sharing is how we build our brand." | BW |

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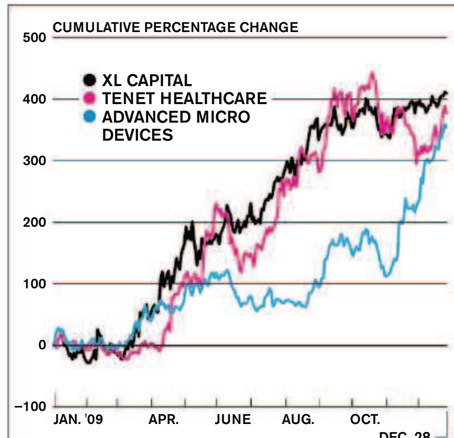
CHECK THAT OPTIMISM



The Standard & Poor's 500-stock index closed above 1,120 on Dec. 23, marking the halfway point between October 2007's peak and March 2009's trough. Evergreen Investments Chief Market Analyst John Lynch says not to get overexcited by the bounceback. Yes, the market could rise from here, especially given the cash that's coming off the sidelines—some $11.1 billion went into U.S. equity funds in the week ended Dec. 23. That was the strongest weekly inflow since June 2008, according to Cambridge (Mass.)-based EPFR Global. But "with a 10% unemployment rate and the chance the Federal Reserve will raise rates, I think 1,200 is as good as it gets," says Lynch. If the S&P hits 1,200, he says, investors should prepare for a pullback to about 1,000. –*T.K.*

MONEY REPORT

S&P SUPERSTARS



Data: Bloomberg

Insurer XL Capital topped the list of best-performing stocks in the Standard & Poor's 500-stock index in 2009, as of Dec. 28. And despite its 410% increase, to 19, analysts are betting the company's share price will continue to rise. On average, analysts covering XL Capital think it can reach 22 by the end of 2010, according to Bloomberg. That's likely a reflection of a recently improved ratings outlook from Moody's Investors Service. Still, the current share price is way off its July 2007 high of 85. The S&P 500's No. 2 performer, Tenet Healthcare, rose 378% in 2009, to 6. Deutsche Bank's Darren Lehrich estimates shares could climb to nearly 10. Coming in third: Advanced Micro Devices, with a 355% leap. But at nearly 10, the stock is about 16% overvalued, according to average analyst expectations for 2010. ¶ Among all S&P 500 companies, analysts expect Iron Mountain, Lennar, Citigroup, Bank of America, GameStop, and J.C. Penney to all rise by more than 35% over the next 12 months. –*Tara Kalwarski*

BONDS

TREASURY TURMOIL

Yields on 10-year Treasury notes rose 0.65 percentage points in December, the biggest one-month increase since April 2004. Morgan Stanley's fixed-income team estimates 10-year notes, which yield about 3.8%, will climb to 5.5% in 2010. That forecast tops the 4% average of 60 economists surveyed by Bloomberg. James Caron, head of U.S. interest rate strategy at Morgan Stanley, believes Treasuries will face increased competition from issuers of mortgage and municipal debt, spurring investors to demand higher yields. Speculators appear to side with Morgan Stanley: Bets that prices on 10-year notes will fall outnumbered bets that they'll rise by 52,781 contracts on the Chicago Board of Trade in mid-December. ProFunds offers mutual funds for investors looking to profit from falling Treasury prices. The Rising Rates Opportunity 10 ProFund, which tracks the inverse of daily prices on 10-year Treasuries, returned more than 4.3% as rates rose in December. –*Oliver Biggadike and Daniel Kruger*

5.5%

Morgan Stanley's forecast for the yield on 10-year Treasury notes in 2010

(LEFT) ANDY FRIEDMAN; CHART BY DAVID FOSTER

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HOW TO PLAY IT | DISTRESSED DEBT


Should This Man Be a Banker?

(FROM PAGE 56)

Third Avenue Funds, run by distressed-investing legend Martin Whitman, rarely launches new mutual funds. But last August, with credit markets on a tear, the New York-based asset manager came out with the Third Avenue Focused Credit Fund. The $420 million fund will hold 50 to 70 picks, including high-yield bonds, bank loans, and distressed debt. Amy Feldman spoke with fund manager Jeff Gary.

Why focus on such a wide range of debt?
The market for the kind of debt in the fund is $2 trillion, with 3,000 companies. Some people say the bargains are gone, but given the size of the universe, the decrease in people researching it, and the distressed opportunities and defaults coming, we think we can find opportunities for many years to come.

How does the flood of new high-yield issuance affect your thinking?
Even though there was $170 billion in new issuance in 2009, almost all went to refinance existing debt. When a lot of leveraged buyouts were done in 2007, the so-called leverage multiple, as measured by debt-to-Ebitda, was 6.7, its highest level. [Ebitda is a measure of cash flow.] Now with lower Ebitda, leverage ratios for many companies are even higher. While the companies can get credit, they're not repaying debt but extending maturity dates. They are pretending they don't have a problem.

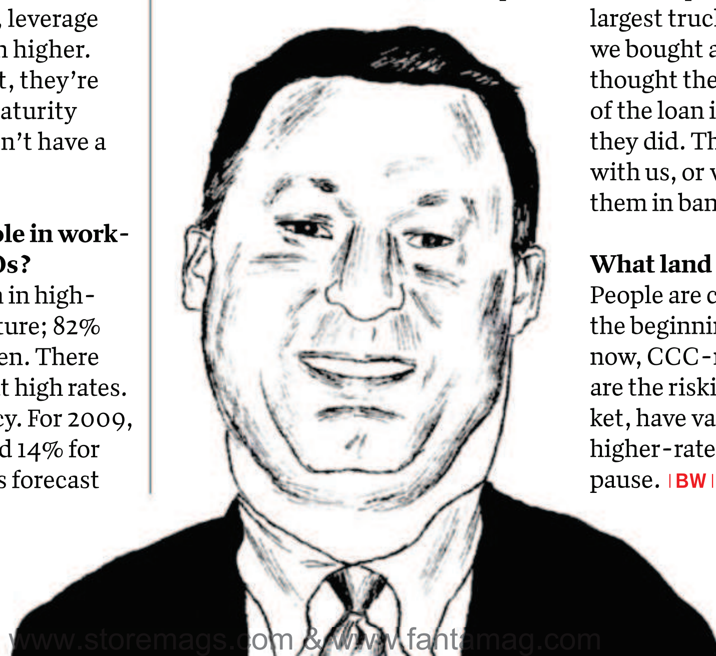
Do you expect to play an active role in working out these over-leveraged LBOs?
Yes. From 2012 to 2014, $850 billion in high-yield bonds and bank loans will mature; 82% of the bank loan market matures then. There will be a need for rescue financing at high rates. Some companies will file bankruptcy. For 2009, defaults were 11% for high-yield and 14% for bank loans. J.P. Morgan's strategists forecast 4% defaults in 2010 and 2011 for both. If you do some calculations, a 4% default rate should correspond to high-yield bonds at 500 basis points above Treasuries, and now that spread is above 700 basis points. Bank loans are trading similarly. That means the market is pricing in a much higher default rate than 4%, and that's reason to be cautiously optimistic.

Those defaults, I assume, mean opportunity for distressed investing?
Companies that file bankruptcy will need debtor-in-possession financing. We will also do financings to help companies exit bankruptcy. We invested in DIP financings for Aleris International, an aluminum products company, and for Tronox, a maker of titanium dioxide. You can get 10% to 18% returns on capital. This is an area where we would like to invest more. I would like to see [those kinds of investments] at 25% of assets.

Performing high-yield bonds are about a third of assets. What do you look for?
Most are companies with good balance sheets, where there is a catalyst to drive the value of its securities higher. We invested in notes of HCA, the country's largest health-care system. It was purchased in an LBO and is now talking about an initial public offering, which would significantly pay down debt. And one of our largest positions is iron ore company Fortescue, based in Australia. Iron ore is expected to go up sharply on demand for steel.

Your top sectors include energy, mining, and transportation. What's the logic there?
One focus of ours is early-stage cyclicals. An example is Swift Transportation, the country's largest truckload carrier, where we bought a secured loan. We thought they'd violate the terms of the loan in September, and they did. They had to negotiate with us, or we could have put them in bankruptcy.

What land mines are looming?
People are chasing yield. From the beginning of the crisis until now, CCC-rated bonds, which are the riskiest part of the market, have vastly outperformed the higher-rated Bs. That gives me pause. |BW|



ANDY FRIEDMAN

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PLANNING

HOW GOOD IS YOUR 401(k)?

by Amy Feldman

Americans increasingly rely on their 401(k) plans for retirement, yet typically understand little about how their plans work, or how they compare with offerings at other companies. Is your 401(k) cheap or expensive? Does it offer good investments or mediocre ones? A generous match or a stingy one? And most important: Will your 401(k), and the way you take advantage of it, get you through retirement without running out of money?

BrightScope, a San Diego startup, wants to help 401(k) participants and administrators answer those questions. It has created a massive database from corporate filings with the Labor Dept., Securities & Exchange Commission, and other sources, to rate 401(k) plans. To mine all that data, it developed a quantitative model that takes into account hundreds of factors—everything from the plan's investment choices and fees to its structure, including its generosity to employees. BrightScope then runs simulations to ascertain how well each plan serves the average participant. The final result is a score of 1 to 100 called the BrightScope rating. The company also assigns each plan six component ratings (on fees, average account balance, etc.) that range from "great" to "poor," so participants and plan administrators can see where the 401(k)'s strengths and weaknesses lie.

This exercise isn't without precedent. Retirement consultants at Callan Associates, Marsh & McLennan's Mercer unit, and Watson Wyatt have long done proprietary analyses—"benchmarking," they call it—for big 401(k) plan sponsors. What makes BrightScope unique is that its ratings are publicly available on brightscope.com, and its analysis has been boiled down to a level anyone can understand. The company now rates about 30,000 plans, double the number it had completed in October.

Mike Alfred, BrightScope's chief executive, believes people should be able to see how their 401(k)s stack up as easily as they are able to access quality rankings on their mutual funds, their cell phones, or their cars. With nearly $3 trillion socked away in 401(k)s, "it's ridiculous that no one has done anything with the data," he says. "The person who gets it right will find the business opportunity. We're just naive enough to think we'll be the ones to do it."

BrightScope's efforts come at a perfect moment. Even before the market meltdown of 2008, Americans were headed for a retirement crisis, with the average 401(k) balance hovering around $60,000. Now, legislators and regulators are debating how to reform these plans and whether there should be new rules on fees, which can seriously damage a plan's performance, or on target-date funds, investment vehicles geared to a specific retirement date that are the default offering in many 401(k)s for participants who do not choose their own investments.

If BrightScope ratings gain acceptance, they could change the retirement world as dramatically as Morningstar's fund ratings altered the investing landscape. More information could help people better evaluate two job offers or arm current employees with information that lets them campaign for better plans. The ratings could also provide a huge service to corporate plan sponsors, particularly small ones that can't afford to hire high-paid consultants to evaluate and improve their plans.



BRAD SWONETZ/REDUX

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BightScope's brother act: Ryan, Eddie, and Mike Alfred

It's too early to say that tiny BrightScope, with just 22 employees, little revenue, and months of red ink, will usher in all these changes. But the business model—a mix of free reports and subscription-based products that offer more detailed analysis—could prove compelling.

The first big hurdle is getting the rating formula right. If BrightScope's data aren't good enough, or its model proves defective, its analysis could be useless, or could even nudge both participants and corporations to make decisions based on faulty assumptions. "It's not as simple as a good plan vs. a bad one," says Lori Lucas, who heads Callan's practice in 401(k)s and other defined-contribution plans. "A mutual fund might have 100 moving pieces. But a 401(k) might have 1,000, making it difficult to come up with a single rating."

On top of these challenges, BrightScope faces other small competitors trying to make a business out of evaluating 401(k)s. Fiduciary Benchmarks in Portland, Ore., tries to gauge retirement readiness based on a more complex income-replacement model—that is, how much of your current income you will need in your post-working years. This includes factors such as estimated payments from traditional pensions and Social Security. The company markets this information and other detailed reports to retirement-plan advisers. London-based PensionDCisions, meanwhile, is gearing up to enter the U.S. market with data on participant behavior within particular 401(k) plans—everything from whether they are using the defaults or choosing their own investments to how often they trade in and out of investments. Neither of these efforts, however, is easily accessible to the general public.

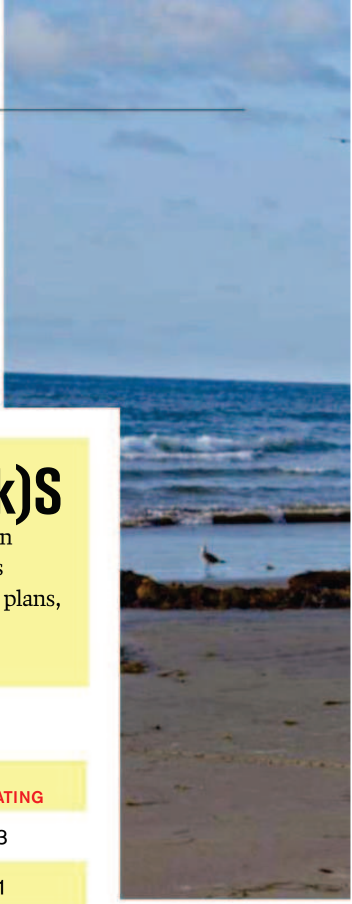
Then there's Morningstar. The firm does not rate 401(k)s and doesn't plan to. But Morningstar Vice-President for Research John Rekenthaler says: "It feels like something we could be doing. ... It seems like a valuable service."

LIGHTBULB MOMENT

The creative energies behind BrightScope belong to two brothers, Mike and Ryan Alfred, 28 and 26, and a middle-aged techie friend of their family, Dan Weeks. A former Hewlett-Packard engineering manager, the 50-year-old Weeks hatched the idea three years ago after becoming increasingly concerned about his own retirement planning. "I could not make sense of Hewlett-Packard's 401(k)," Weeks says. "Everyone I knew at HP was deciding randomly where to invest."

Neither the Alfred brothers, who were then running a financial advisory business, nor Weeks knew much about 401(k) plans when they sat down to discuss the idea in the fall of 2007. One evening in October, with *Monday Night Football* playing in the background and glasses of Maker's Mark in hand, Ryan says, a light went off. That's when they realized it was the 401(k) plans themselves that they should be rating. "You know when you start thinking faster and you start talking faster," he recalls. "I started taking notes on my Black-

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Berry, and soon had five pages of thoughts."

In 2008, Weeks quit his job, and the brothers, who had begun as consultants on the project, signed on full-time. A third brother, Eddie, an undergraduate at Harvard, took a leave of absence to join them. They lined up a first round of investors for about $1 million and raised double that amount in a second round in 2009.

BrightScope hired a team of data entry workers to plug in information on hundreds of plans a day and launched its public Web site in late January, 2009. In July the company launched a product called Plan Management Dashboard for corporate plan sponsors and followed up in September with Advisor Central for retirement-plan advisers. Matthew Hutcheson, an independent fiduciary who works with 401(k) plans and is on BrightScope's advisory board, says he has purchased the Dashboard for all his clients. "BrightScope is chipping through the rock to find this valuable information," says Hutcheson, who says some clients have made changes to their 401(k)s because of the data.

Yet while BrightScope's efforts at rating 401(k)s look a lot like Morningstar's in funds, it's a much more difficult exercise, in large part because the publicly available data is problematic. Companies with 401(k)s are required to file paperwork, called Form 5500, with the Labor Dept. It details the size of the plan, the number of participants, the investments available, and the like. As with other types of government data, though, the information on those forms may be as much as two years out of date. It's also riddled with inconsistencies on basic matters, such as which industrial category a company selects to classify itself. And while consumers can easily look up the symbol of a retail mutual fund, that's often not possible with institutional offerings, which are investment vehicles geared toward large investors and which administrators of the best 401(k)s favor because of their lower fees. "The data is hard to get, and you have to make assumptions," Ryan says. "There's a subset of plans where even if you have the data, they are unratable because there are too many gaps."

BrightScope hopes that as its ratings gain acceptance, those in charge of the 401(k)s will fix errors or misunderstandings that arise from their filings. This happened soon after launching the Web site last January. "We were about to go to the launch party, and Chevron e-mailed to say that they believed they had the best match in the industry. They were filing something that no one else files that way," Ryan says. A few tweaks of the data and the information was fixed, giving Chevron a much better rating.

In the long term, rather than waiting for government information, BrightScope would like to obtain data feeds from the companies or the

BEST AND WORST 401(k)S

Oil companies and financial firms dominate the top 10 in BrightScope's ratings of the best and worst 401(k) plans holding more than $1 billion. For a longer list of the best plans, go to http://www.businessweek.com/go/09/best401k

THE BEST

PLAN	ASSETS (IN BILLIONS)	RATING
Saudi Aramco	$1.4	93
UAL (pilots' plan)	3.1	91
Wellington Management	1.0	89
Southwest Airlines (pilots' plan)	1.6	87
Charles Schwab	2.4	86
ConocoPhillips	10.4	86
Chevron	15.4	86
ExxonMobil	24.2	86
Credit Suisse Securities (USA)	2.5	86
Amgen	2.1	86

THE WORST

PLAN	ASSETS (IN BILLIONS)	RATING
Danaher (savings plan)	$1.3	26
Wal-Mart	11.0	28
Safeway	1.4	40
Tyson Foods	1.1	42
UAL (ground employees plan)	1.7	45
Sysco	1.4	45
UAL (mgmt. & admin. plan)	1.1	46
Publix Super Markets	1.3	47
Sears Roebuck	4.0	47
Tenet Healthcare	2.8	48

Data: BrightScope

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Co-founder Dan Weeks "could not make sense" of his 401(k) at Hewlett-Packard

BRAD SWONETZ/REDUX

firms that are responsible for managing 401(k) plans on their behalf. Given the tight control that large recordkeepers like Fidelity and Vanguard keep on data, and the security issues involved, that's unlikely to happen on a large scale any time soon. But Invest n Retire, a recordkeeper based in Portland, Ore., is now sending its clients' data to BrightScope on a trial basis. "I hope BrightScope will get momentum," says Darwin Abrahamson, chief executive at Invest n Retire. "I've looked at some plans and said, 'My God, I cannot believe it had such great matching, yet had low account balances, high fees, and low investment quality.'" If the company is going to spend the money on matching, he says, "it needs to correct the other problems, too."

NAILING THE NUMBERS

But what makes a retirement plan good or bad? And how do you account for so many different factors and for the wildly divergent demographics of companies, large and small? BrightScope started with two simple premises: The rating would be based on quantitative factors only, and it would be designed to measure how well the plan was creating retirement income security for its participants. To turn those ideas into a metric, Ryan—with the help of academics like Allan Timmermann, a professor of finance at University of California at San Diego—built a model that simulates "retirement readiness." They fed into it some 200 variables, which fell into two categories: items that are within the sponsor's control, such as the vesting schedule, the eligibility period, the available investments and their associated fees; and items that are up to the employees, such as whether to participate and how much to contribute.

The team then ran some 10,000 simulations of a hypothetical 44-year-old employee's retirement readiness. This analysis gets boiled into the BrightScope rating. Today the highest-rated plan with assets of more than $1 billion, Saudi Aramco, rates a 93; the lowest, one of the plans of manufacturing conglomerate Danaher, scores just 26. "A 100 rating would be, 'You're retired, here's $1 million, and thank you for working for us,'" Ryan says.

The trouble is, just the act of creating a rating raises issues about what is being measured and how. Some retirement experts question BrightScope's decision not to account for retirement benefits outside the 401(k), such as pensions or profit-sharing plans. Intel's 401(k) has a ho-hum overall rating of 75, for example, partly due to low marks for company generosity. Yet Intel makes hefty contributions to a separate profit-sharing account, says Stuart Odell, Intel's assistant treasurer of retirement investments. All employees receive this contribution, even if they don't sign up for the 401(k), and it has never been lower than 6% of pay—far greater than the typical company match in a 401(k) plan.

Another potential pitfall: BrightScope's list of top 401(k) plans is dominated by industries such as oil, financial services, and pharmaceuticals, where the workforce is well-paid and stable. Higher-paid employees are more likely to participate in their companies' 401(k)s and to contribute at higher levels, both of which are factors that impact the BrightScope rating. Stephen Utkus, head of retirement research at Vanguard, calls the BrightScope analysis "a useful framework," but notes: "If you are ranked by BrightScope with a 60 or 70 and think you have a mediocre plan, you may not. You may just not work in a high-paid industry."

What BrightScope lacks in nuance and complexity, however, it gains in accessibility. Keeping the ratings user-friendly is one of BrightScope's strengths—and it will remain a priority, says Mike Alfred: "I think we're at the early stages. Who's to say we couldn't rate pension plans or health plans?" |BW|

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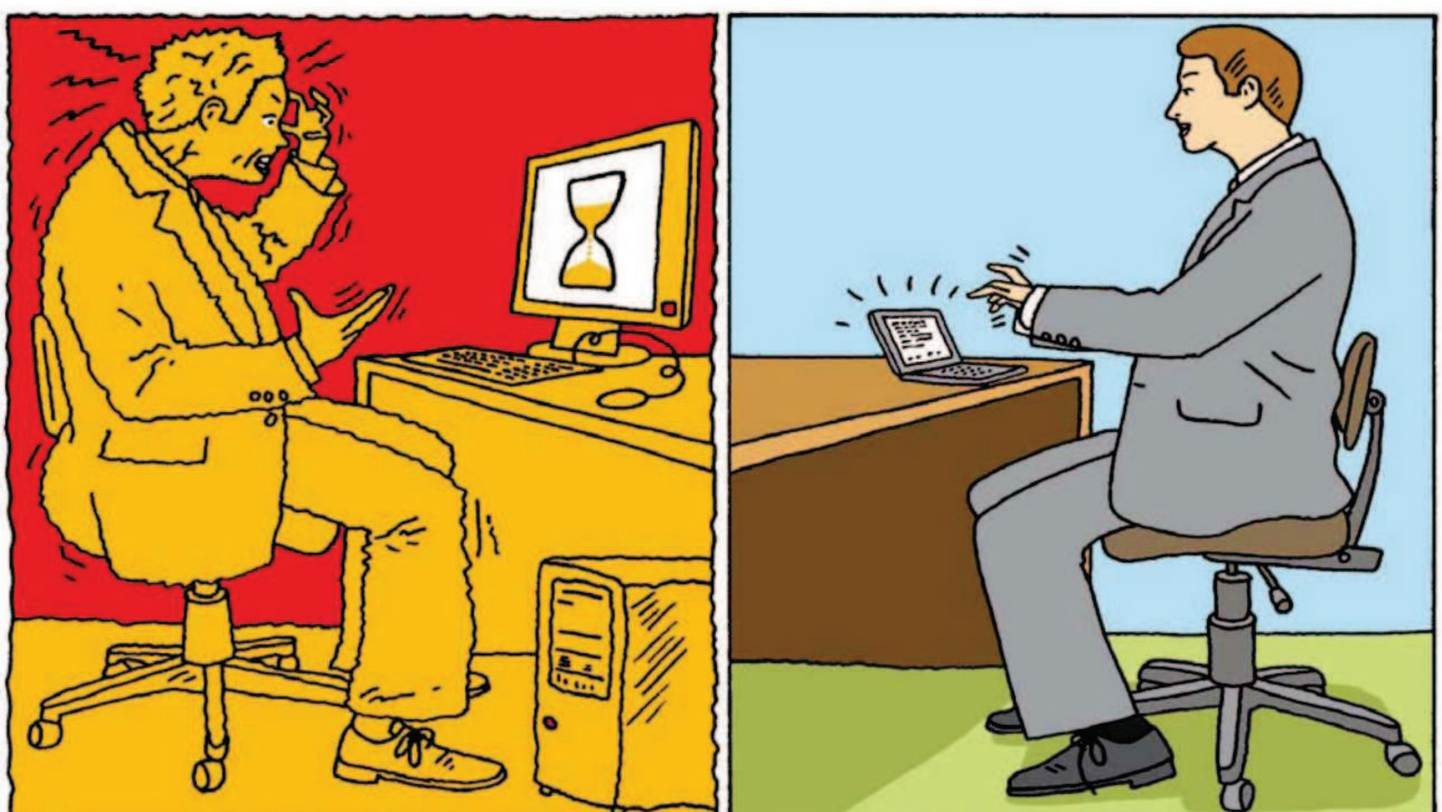
BUSINESS VIEWS

TECH & YOU By RICH JAROSLOVSKY

Logging on At Warp Speed

Booting up can feel like an eternity. Here's how to get closer to the "instant-on" PC

It took about 20 years for TV technology to reach the point where viewers no longer had to wait for their sets to warm up. Yet here we are, 30-plus years into the personal computer era, and the PC that turns on instantly remains elusive. ¶ That may be about to change. Today's tech-loving consumers have



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grown accustomed to always-on smart phones and efficient netbooks they can leave for hours in "sleep" mode without rebooting. As a result, they're quickly losing patience with the spinning logos, hourglasses, and twiddling thumbs that define the experience of booting up a Windows PC. And they are showing a growing interest in hardware and software that speed up the process, or in some cases sidestep it entirely.

By most accounts, Windows 7, the current version of Microsoft's operating system, is quicker off the mark than its predecessor, Vista. Microsoft says it works hard with partners such as Lenovo to optimize boot-up times and says Windows' sleep mode is more or less the equivalent of instant-on. But the U.S. Energy Dept. says constant use of sleep mode wastes electricity. Here are three ways to speed things up:

RUN A SECOND OPERATING SYSTEM. A number of programs aim to solve Windows' slow boot times by simply not booting Windows. Instead, these programs—some of which come preinstalled on new computers from Dell, Hewlett-Packard, Asus, and Acer, among others—instantly launch a stripped-down desktop that allows you to surf the Web, handle any e-mail you can view in a browser, and perform other basic tasks. Windows is there, but only when you really need it.

I've been using one such program, HyperSpace from Phoenix Technologies, on a Samsung NC10 netbook for the last couple of weeks, and even starting up cold, the speed is impressive. Press the power button and in 15 seconds the Linux-based HyperSpace presents you with a customizable screen including a Web browser, a notepad application, and RealPlayer media software, along with news, weather, and stock information. I jotted a quick note, watched videos on YouTube, and made calls using Skype, all without launching Windows.

The experience became a little less satisfying, though, once I hit the icon on the HyperSpace desktop to start up Windows. Instead of allowing me to keep working while the second operating system booted up, Windows took over the desktop and loaded at its usual leisurely pace. In other words, HyperSpace doesn't eliminate the wait, it just delays it.

Moreover, while the two systems exist side by side, jumping back and forth between them sometimes poses problems. Especially when the Netbook was running on battery power, I faced long pauses where nothing seemed to be happening on the screen. Do I keep waiting? Do I click again? If you're like me, you may eventually find yourself doing fewer and fewer things within Windows.

20
Seconds
The time it takes to boot up a Dell Latitude notebook with a solid-state disk drive

GO SOLID-STATE. Conventional hard drives are mechanical devices that stash your data on spinning platters and take time—precious seconds—to retrieve it. Solid-state drives, by contrast, have no moving parts; information, including everything the operating system needs to boot up, is stored on microchips and is instantly accessible. As a result, SSDs are faster and use 80% less power, according to Samsung, which, along with Intel, makes the drives.

I've been using a Dell Latitude E4300 notebook outfitted with a 256-gigabyte Samsung SSD. No second operating system needed: The experience is pure Windows 7—at light speed. The Latitude rockets from zero to ready for action in a mere 20 seconds. Just about every other function gets a speed boost, too, and the computer shuts down in five seconds.

Alas, the speed comes at a stiff price. Putting an SSD in the Dell adds about $700 to its price, compared with a regular hard drive of similar capacity. In other words, solid state is the way to go, but only if you've got the dough.

GET RID OF WINDOWS ENTIRELY. There are more operating-system alternatives to Windows today than at any point in the last two decades. And the options are increasing. Most obviously, there's Apple's OS X. The current version, Snow Leopard, boots somewhere between 10% and 15% faster than Windows 7, according to most tests. While that's good, no one would describe a Mac as "instant-on."

For those with less money in their wallets and more adventure in their souls, there's Ubuntu, a free, consumer-oriented version of Linux with startup times comparable to HyperSpace. And lurking in the wings is Google, which is promising its own operating system, Chrome OS, for 2010.

Chrome OS was designed with instant-on in mind. At its public debut this summer, Google executives showed a netbook reaching its log-in screen seven seconds after powering up, and said they were working to bring that down even more.

All these developments put Microsoft on notice that it is going to have to move more quickly to retain its dominant position. Speaking for computer users everywhere, I can't wait. |BW|

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Business Exchange

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What is Google's New OS?
We won't have the full answer until the Chrome operating system arrives later this year, but Google has put helpful clips on YouTube.

To see these and other stories on Chrome, go to **http://bx.businessweek.com/google-chrome/reference**

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BOOKS

By HEATHER GREEN

Wake Up and Smell the Zeitgeist

Sensitivity to cultural shifts may not be common at most corporations—but it's an art that can be learned



Is it possible to clone Steve Jobs or Martha Stewart? That's the question at the heart of *Chief Culture Officer: How to Create a Living, Breathing Corporation,* by Grant McCracken, an anthropologist at the Massachusetts Institute of Technology and a business consultant. McCracken argues that corporations need to focus on "reading" what's happening in the culture around them—a task at which Jobs and Stewart excel. Otherwise, companies will suffer the consequences, as Levi Strauss did when it missed out on the rise of hip-hop (and the baggy pants that are part of that lifestyle).

McCracken doesn't advocate that companies launch an extensive search for an all-knowing guru or rely on so-called cool hunters or design agencies. Instead, he believes the skills of a Steve Jobs, often viewed as exceedingly rare, are in fact reproducible: They can be learned by managers and made a part of doing business. Offering examples of failures and successes in culture-reading, McCracken dishes up good helpings of practical advice.

At present, says McCracken, most companies do a lousy job of sensing cultural currents. That's because they tend to concentrate on what he calls "fast culture," the kind tracked by cool-hunting, whether it's the latest Italian furniture design or this week's hottest iPhone app. Too often that means companies miss slow culture, the kind that makes up the fabric of people's lives. Homeyness, or how we turn our houses into a home, is an example of slow culture. Former Procter & Gamble Chairman A.G. Lafley understands slow culture, McCracken says, and because Lafley gets it, he changed the way P&G studies people. Instead of using narrow focus groups to examine why a consumer prefers one toothpaste over another, Lafley got company researchers to look at how people generally lived their lives and how the choice of toothpaste fit in.

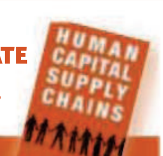
***Chief Culture Officer: How to Create a Living, Breathing Corporation* by Grant McCracken; Basic Books; 262 pp.; $26.95**

Some of the changes McCracken discusses will sound familiar to most readers. For instance, it's a cliché that consumers are producers of culture these days and that companies must embrace this shift. The book's most helpful chapters offer how-tos and profile executives who've become culture officers within their companies.

For example, there's Silvia Lagnado, global brand director for Unilever's Dove products. Lagnado's fresh take on consumer research data led her to upend beauty marketing. When she looked at global ads, the models were mostly "young, white, blond, and slim." That comes as no surprise, but the impact of such homogeneity is enormous. According to a survey of women worldwide, only 2% consider themselves beautiful. Rather than accepting the marketing status quo and emphasizing other aspects of Dove products, such as healthiness, Lagnado embraced inclusiveness, creating the "Campaign for Real Beauty" that starred ordinary women.

McCracken's how-tos include the development of soft skills people often don't appreciate, such as the skill of noticing. Advertising firm Crispin Porter Bogusky remarked that, though Apple's funny "Mac vs. PC" ads seemed to put people in either the avant-garde camp or the square mainstream, a growing group of people didn't want to be labeled at all. So the firm dreamed up the "I'm a PC" campaign that made it seem cool not to be hip. McCracken also purveys more specific advice, including a list of deep thinkers to lunch with, such as new-media whiz Jerry Michalski.

While McCracken's book is full of managers who read culture well, it's obviously not easy to develop the keen receptors of a Jobs or a Martha Stewart. But maybe that's asking too much. The book makes a compelling case that companies will reap rewards just by working toward more cultural sensitivity. Those inclined to try will get plenty of inspiration and insight from McCracken. | BW |

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OUTSIDE SHOT

By BILL CONATY

Cutbacks: Don't Neglect the Survivors

How to keep the delicate ties that bind employees to their companies from snapping

Restructurings, consolidation, salary freezes, a shifting health-care cost burden, furloughs, 401(k) match eliminations...this list, as you know, goes on and on. Did your company cancel this year's Christmas party?

These are common responses to our changing corporate landscape. And they can be necessary. Businesses that don't step up and react to reality are unlikely to survive over the long term.

My concern is that, cumulatively, these negative actions are tugging at and fraying the delicate bonds of loyalty that tie employees to their employers. I believe it will be the companies that manage to deftly balance the necessary tough competitive actions with genuine compassion for their employees that will win big in the future.

People have long memories. What they don't have right now are a whole lot of career options. And they will judge their employer by how equitably they feel they were treated during the down market. So how exactly do you steer your company through this in a way that won't drive your people into the arms of the first headhunter who calls? (Trust me, they will start dialing again.) Just as vital: How to take the tough steps while energizing your workforce instead of paralyzing them?

As counterintuitive as it may sound, consider going deeper than you might on staff reductions, rather than nibbling around the edges hoping for a quick market turnaround. Some companies believe in "share the pain" scenarios, where everyone gets to sacrifice equally at the corporate altar. I'm not a fan of such strategies unless they address a short-term crisis in which a company expects to be reducing forces and hiring within the same year. In my view, these practices ensure that 100% of your workforce is demoralized, vs. the 10% to 20% whom you really can't afford in the current climate.

When you're ready to make those cuts, deal compassionately with the casualties, financially and emotionally, to provide them as soft a landing as possible. Career transition centers, training opportunities, and a sincere interest in helping those who are moving on become more marketable will genuinely help.

Many companies don't need to be told that. Instead, managers often spend a disproportionate amount of time managing the layoff process and not enough attention on the surviving talent. Those survivors need to be recognized and rewarded. Yes, they'll pay close attention to how humanely layoffs are carried out, but they're also aware that their own workload and stress level has just been stepped up. You want this group to play offense, not to fret over when the next shoe will drop or feel that they're being overburdened.

With financial rewards temporarily off the screen, an astonishingly powerful form of recognition is a genuine pat on the back, along with words along these lines: "I think you're doing a great job under tough circumstances, and you're an essential part of my team." It doesn't take long to say or cost a penny, but how many of us have ever heard those words?

There's a strong tendency for executives in tight spots to simply clam up, fearing they don't have the answers people want to hear. To avoid appearing inadequate, they'll issue the occasional all-employee e-mail or canned Webcast. But you'll find that you don't need to have all the answers. You'll discover that the rumor mill has painted the most pessimistic picture imaginable, and you will quickly be able to dispel numerous falsehoods and present a clearer and more optimistic view. These times call for a personal touch. Employees who get to see and hear their leaders are far more likely to buy into a future beyond the crisis.

Now back to the subject of holiday parties: It's a mistake to legislate fun out of the workplace. You need to continue to celebrate, especially in tough times. Employees shouldn't feel that it's wrong to appear to be having fun at the risk of their superiors thinking they're not serious enough. We need to dial down how we celebrate, yes, but it's not natural to have to continuously wear a deadly serious game face. Life's too short to have to feel that way, let alone act that way.

As the clouds blow away, I'll be placing my bets on companies that are the most open, ethically compliant, and compassionate with their people. They'll be the ones that succeed in retaining—and therefore attracting—world-class talent. |BW|



TAMARA SHOPSIN

Bill Conaty is a former senior vice-president for human resources at General Electric and is co-authoring a book with Ram Charan tentatively titled The Talent Masters.

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